SUSTAINING SOCIAL SAFETY NETS

Critical for Economic Recovery

Alejandro Foxley

Carnegie Endowment
for International Peace
WASHINGTON DC ▪ MOSCOW ▪ BEIJING ▪ BEIRUT ▪ BRUSSELS

Sustaining Social Safety Nets:
Critical for Economic Recovery

Alejandro Foxley

CARNEGIE ENDOWMENT
FOR INTERNATIONAL PEACE
WASHINGTON DC ▪ MOSCOW ▪ BEIJING ▪ BEIRUT ▪ BRUSSELS

For electronic copies of this report, visit www.CarnegieEndowment.org/pubs.

Carnegie Endowment for International Peace
1779 Massachusetts Avenue, NW
Washington, DC 20036
Phone: 202-483-7600
Fax: 202-483-1840
www.CarnegieEndowment.org

Contents

Preface

This report is part of a project on the impact of the current global financial crisis on the reform agendas in middle-income economies. Three groups of middle-income countries are included, in Eastern Europe, East Asia, and Latin America, where emerging economies have good prospects of making the transition from the developing to the developed world in the next fifteen to 20 years. In fact, these countries are already halfway there, with economic and social markers such as GDP per capita and human development indicators that could converge with those of the pre-crisis Southern European economies.

Although these three groups of countries are not at the forefront of today's concerns about peace and security, they include many countries with nascent democratic systems. In the wake of the global crisis, solid reform agendas would strengthen these democracies and help them cross the threshold to become developed economies. The developing world needs real success stories for other emerging democracies to follow. And conversely, even developed economies might learn from the successes and failures policy makers in middle-income countries have had in managing the crisis and enacting reforms in response to the worldwide recession.

Summary

The current global financial shock will be followed by a long period of abnormally high unemployment, and by severe pressure to reduce government expenditures, once the fiscal stimulus runs its course. As a consequence, the coverage and quality of basic social services—from unemployment insurance to health care and social security—may suffer. At the same time, the recession is reducing household income, and thus many households that cannot afford privately provided services will face increasing difficulties in accessing underfunded public services. Significant segments of the middle class might slide back into poverty.

This report focuses on these issues, taking as case studies three groups of middle-income countries—in Eastern Europe, East Asia, and Latin America. All these countries have gone through repeated financial shocks since the 1980s, and they have all attempted to improve their social safety nets, either by increasing public funding for social services or relying on mixed private–public systems, funded by employers and employees through mandatory or voluntary contributions. In a few cases, countries have pursued the privatization of services like social security, with mixed results.

The principal conclusions of this comparative study are as follows:

- The more open an economy and the more democratic its political system, the higher the pressure to increase expenditures in the social sector will be.

- Good macroeconomic policies pay. They allow countries to implement countercyclical social policies during a downturn, as many Latin American economies have done during the current global crisis. Bad macroeconomic policies get governments into trouble, causing social safety nets to deteriorate, and the political consequences can be severe. This has been the case for the Eastern European economies of late.

- When it is necessary to strengthen social safety nets in a democracy, it is more efficient to undertake reforms within the existing institutional framework. If the system is predominantly public, the problem of inadequate funding and low quality of services must be tackled. If the system is predominantly private, the challenge is to reduce costs through more competition, including instituting a public option.

- Democracies require more equality if they are to grow stronger. The problem is that globalization pushes in the opposite direction; by placing a premium on high skills that make workers more competitive, it increases income inequality between the highly skilled minority and the rest. In this situation, it is not sufficient to reduce economic insecurity by expanding the social safety net. Instead, a country must begin to make the transition from a welfare state to a workfare state, with an emphasis on creating a more highly skilled labor force, and improving access to the labor market for women and low-income youth. To expand job creation, new social policies must also provide better incentives for entrepreneurship and innovation. Only then can social policies be considered key factors of production, beyond their role as instruments of social protection.

Introduction

This study deals with social safety nets and how they will need to be restructured to remain effective after the global financial crisis. Why should we be concerned about social safety nets? The current, albeit slow, recovery from the world recession is a consequence of, among other factors, a substantial fiscal stimulus by all major and even small economies.

However, as the recovery unfolds, the focus of policy makers, and particularly of central bankers, will shift toward the potential side effects of the large expansion in public expenditures. Inflation and public debt will rise, and the pressure to slow the economy by increasing interest rates and contracting public spending might become the order of the day.

In a realistic scenario, this will happen before the major economies have returned to normal levels of economic activity. Growth rates will be modest and below potential, and thus unemployment will remain unusually high for several years. As a consequence, those already unemployed will spend abnormally long periods searching for jobs. There is already evidence that this is happening in the U.S. economy, where the number of those unemployed for six months or longer is steadily rising. And this high level of extended unemployment will be a worldwide phenomenon.

As a result of this severe unemployment, existing social safety nets will become stressed and their weak spots will be more visible. Countries will be forced to cut government expenditures to rein in the deficit. Budget cuts will probably lead to reduced coverage in basic social services. Under this scenario, a significant number of the unemployed might face a traumatic chain of events.

For instance, if unemployment benefits are shrinking, and basic health care coverage is deteriorating, one member of a family contracting a serious illness will be enough to push the family into a poverty trap—and this situation could afflict a significant number of families in the so-called emerging middle class. This phenomenon has been observed repeatedly during past financial shocks in most middle-income countries. Moreover, because the current crisis is global rather than regional, the impact will be felt throughout the world.

The reaction of policy makers will vary, depending on the institutional framework of their nation's social safety net. If the predominant component is publicly funded, a response might be to nominally maintain universal coverage for health care, social security, and unemployment benefits but to reduce expenditures de facto, forcing lower replacement rates for pensions and for unemployment compensation,[1] along with a deterioration in the quality of health care services. Those in urgent need will have to increase their out-of-pocket expenses to cover health services.

If the predominant component of a nation's social safety net has been moving toward privatization, when a nation is faced with tight budget constraints and severe deterioration in the quality of social protection, it will probably face renewed pressure to "complete the task" of privatizing its basic social services. This reform process advanced significantly in some Latin American economies in the 1980s and in Eastern Europe in the 1990s, but it was seriously resisted by large segments of public opinion, labor organizations, and key political groups. Now, because the International Monetary Fund is back on the scene in many countries, a renewal of its previous alliance with technocrats trying to balance public accounts might push for further privatization of social services.

If the predominant component of a nation's social safety net is private, as with health care in the United States and East Asia, the main concern will be the impact of rising costs on families affected by the economic crisis. For those not covered by the system, the impact of the crisis might well be devastating. In this case, the focus of the discussion will shift, as is already happening, toward the oligopolistic structure of private-sector providers and the consequent need for a public option to contain costs; and additionally, on finding resources to subsidize those families that cannot afford expensive privately provided services.

Given these alternative scenarios, it is quite possible that the public discussion of these issues will again become highly ideological. Privatizers will be denounced as “neoliberals” and “Washington Consensus” types. Private health care providers and insurance companies will be characterized as not too different from the big banks and hedge funds responsible for the current crisis. On the other side of the fence, those arguing for a public option and a larger role for the state in social protection will be accused of being statist or even old-fashioned socialists.

However, if some degree of rationality prevails in the debate about these issues, the tendency to reform social welfare systems will probably lead to some combination of the two alternatives—public with a private component (partial privatization) or private with a more significant state presence. How these two combine will be critical and, indeed, may possibly lead to one benign outcome—a kind of positive-sum game, whereby the public and private sectors together serve as complementary components of a comprehensive, strengthened social protection network.

Yet there could be another, not so benign outcome, whereby public- and private-sector providers would regard each other with suspicion and not look for areas of cooperation or even compete—they would just ignore each other. This could end up creating a segmented system of social protection. The well-off would go private, with high voluntary or mandatory contributions to finance services, as in Chile, whose services are of good quality but expensive. The rest would go public, with access to underfunded public services of lower quality. And there would be no redistributive mechanism between the two. Such a “hybrid” system would certainly breed discontent and dissatisfaction in large segments of the middle class and would have a clear political consequence: an invitation to populist responses from political leaders.

Whatever the outcome of the dispute, the aftermath of the current global financial crisis will make it obvious that an active role for the state is unavoidable to cover the most vulnerable groups of the population and to mend existing social safety nets in terms of cost and accessibility.

Why Study Social Safety Nets in Middle-Income Countries?

Middle-income countries have already experienced some of the dilemmas described above for extended periods. Numerous experiments to improve social protection have been carried out since the democratic transitions of the 1980s in many countries in Latin America, East Asia, and Eastern Europe. The repeated financial shocks of the 1980s and 1990s forced these nations to reconsider previous changes and reforms, and to adjust to severe fiscal constraints and new needs emerging in rapidly modernizing economies.

For those countries at intermediate levels of development, the problems become much more complex. There is less poverty but more economic insecurity due to constant exposure to the fluctuations of the global economy. A new factor is that of an emerging middle class, whose members have strong expectations of expanded opportunities but at the same time are aware of the constant risk of backsliding into poverty when shocks occur in the economy.

In middle-income societies, moreover, there is a constant demand for the state to deliver more public goods, including better coverage and quality in basic social services such as health care and education, and at the same time to build a stronger, more inclusive social safety net. And this progress should be achieved, according to middle-income groups, without increasing taxes and while expanding job opportunities.

Additionally, there are new sources of insecurity that are common to these countries and also to more developed ones. Aging populations, a rapid increase in single-parent families, urbanization, and the need to contain crime are some of the new challenges for social policies in the wake of the global financial crisis.

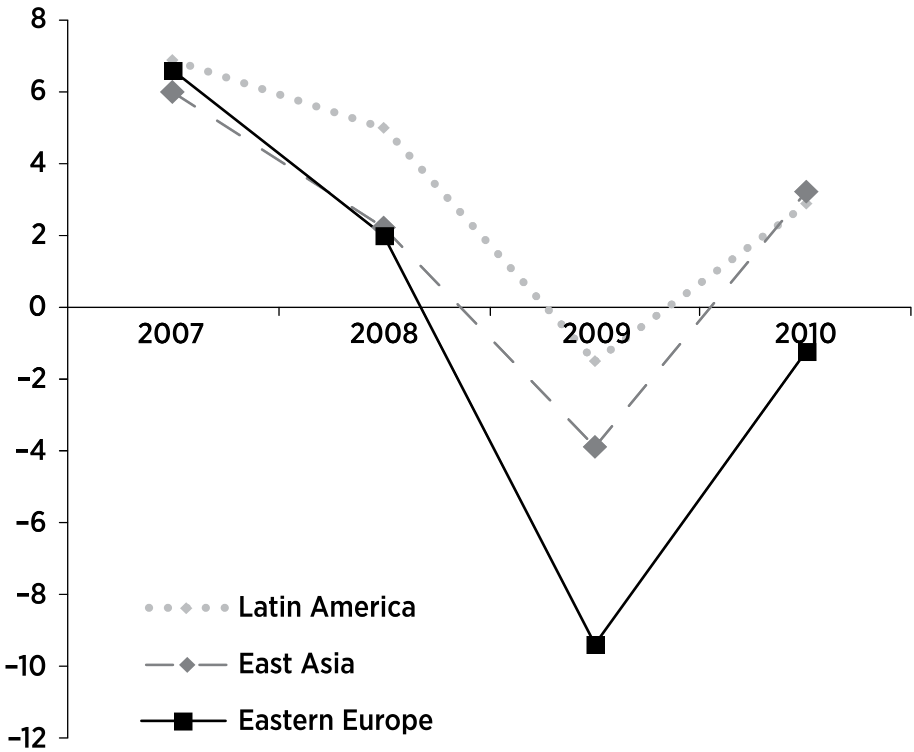
Middle-income countries' past experiences in reforming and modernizing their social safety nets provide a fertile source of information about what has worked or not worked. Some of those lessons might even prove useful for current discussions about these same issues in developed countries.

It is clear that middle-income countries are not at the center of the world's security and peace concerns. But these nations are still relevant—there are many of them, and they are mostly democracies, albeit not entirely mature. In these developing countries, where institutions and services may not work well, healthy macroeconomics will surely help strengthen democratic institutions. And social protection is just as necessary, though it has not yet received sufficient attention. The current global financial crisis is a good opportunity to try to redress this imbalance.

The Global Financial Crisis and Its Impact on Middle-Income Countries

The current global financial crisis has exacerbated the perception of economic insecurity in middle-income countries.[2] Growth rates have been negative for the three regions considered in this study, as shown in figure 1. Eastern Europe has been hit worst by the crisis, with an expected growth rate close to –10 percent for 2009 and still negative in 2010. Negative growth rates mean a fall in revenues and higher budget deficits for all these regions. A consequence will be increased public debt to finance budget deficits, and an almost certain cut in public expenditures, including for the social sector.

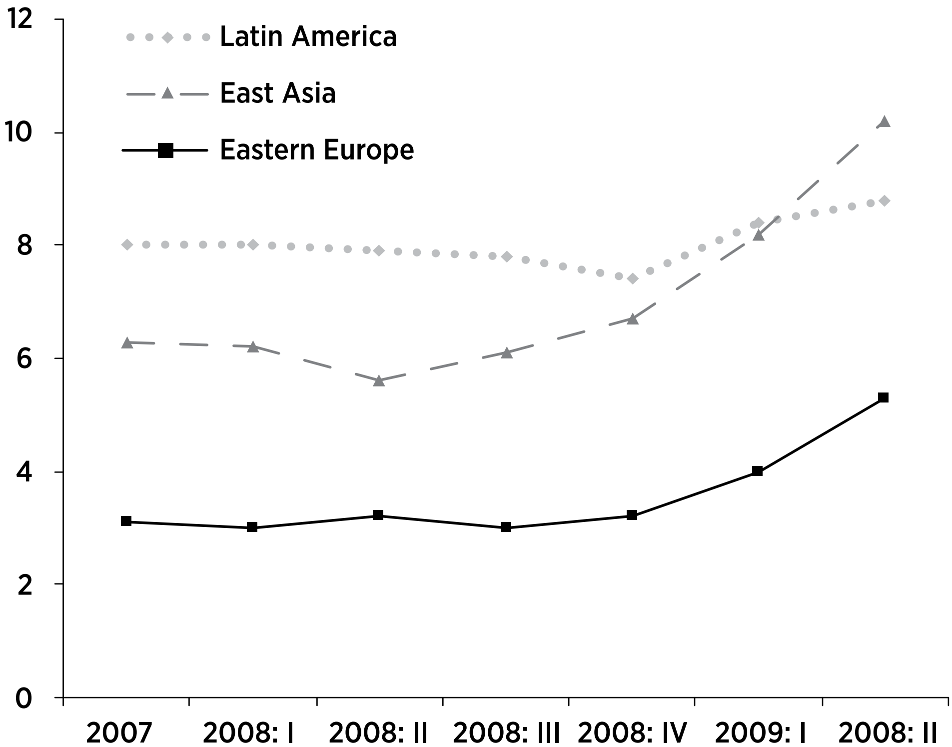
FIGURE 1. Real Gross Domestic Product, 2007–2010
(annual percentage growth rate)



Sources: IMF 2009a, 2009b, 2009c.

The other negative impact of the financial crisis is on unemployment. During 2009, the average jobless rate has gone up to 9 percent for Eastern Europe and Latin America, although in East Asia, unemployment has only increased from 3 percent in 2007 to 5 percent by mid-2009 (see figure 2).

FIGURE 2. Unemployment, Annual and Quarterly Rates, 2007–2009 (percentage of labor force)



Source: International Labor Organization, Laborsta Internet Database (http://laborsta.ilo.org).

Note: The data shown for each quarter (2008: I and so on) represent the three-month average (December–January–February, March–April–May, June–July–August, and September–October–November).

The prospects for reducing unemployment do not look good. If previous global financial crises tell us something, it is that normal rates of unemployment will not be restored for at least five years.[3] However, it will make a big difference if households covered by unemployment insurance do not lose their health care benefits because of a job loss, can continue paying reasonable fees for their children's education, and can expect access to reasonable pensions when their members reach retirement age—in other words, if the social protection network continues to function effectively for them.

Conversely, if households are not covered by a social protection network, there will be a cumulative impact on social welfare resulting from the loss of a job—families will be unprotected when facing a severe illness, education fees, mortgage payments, or retirement. If this were to be the case, there would be a high likelihood that many families, including significant segments of the middle class, would relapse into poverty. How permanent these negative social consequences of the crisis become will in turn determine the severity of its effect on the political system. Thus, to reiterate, a prolonged economic crisis with inadequate social protection will result in some form of "democratic fatigue," accompanied by social conflicts, polarized politics, and even the collapse of elected governments. This has already been the case in the Czech Republic, Hungary, Latvia, and Romania in the first nine months of 2009.

The attention of economists and analysts in general has so far concentrated on the macroeconomic adjustments forced by the global financial crisis—mainly the need for a fiscal stimulus and for more effective regulation of financial markets, along with the additional capital required by the international financial institutions, including the regional banks, to support recuperation from the growth relapse. However, the president of the World Bank has recently requested a substantial capital increase "for middle-income countries," thus recognizing that many in this category face a very difficult transition from recession back to normal growth rates.[4]

The intent of this report is to shift the focus away from the macroeconomics of the recovery and toward the capacity of middle-income countries to protect their populations from the potentially severe effects of current and future shocks while maintaining economic opportunities for their people. To do this, we need to consider social safety nets, examining how they have evolved through time and whether they have been capable of providing minimal economic security during past and current crises, and if the answer has been negative, what reforms should be pursued. Mistakes here would have long-term adverse effects not only for growth prospects but also for democratic institutions and political stability.

The Evolution of Social Safety Nets

To understand the policy dilemmas faced by middle-income countries seeking to implement social policies during the 2008–2009 global financial crisis, it is necessary to review the evolution of welfare systems during the last three decades for the main economies of Eastern Europe, East Asia, and Latin America.[5] During these decades, there have been four sources of pressure to transform existing social welfare programs. The first factor common to most countries in all three regions has been the transition from authoritarian regimes to democratic institutions. Under democratic administration, governments must deliver more inclusive and better-quality social services.

The second factor is the recurrence of financial shocks, particularly in Latin America and Asia. Pressure to improve and extend the coverage of social protection networks becomes recurrent, and often urgent for a government's stability.

The third factor is the pressure for change stemming from the new vulnerabilities of modern societies resulting from changes in family structures, demography, urbanization, and the need to improve the quality of human resources so as to remain competitive in a globalized economy.

The fourth and final factor is that the international financial institutions—which performed a significant role in the 1980s and 1990s in pushing for the types of reforms undertaken by the Eastern European, East Asian, and Latin American countries, particularly of pensions and health care—are being invited back to the table because of the current global financial crisis, and thus they will have an influence on the redesigning of social policies as the crisis abates.

Eastern Europe's Changes in Safety Nets

The first big change in Eastern Europe was caused by the transition to democracy in the late 1980s and early 1990s.[6] The region's communist states had provided for the employment of the entire population and guaranteed universal access to education, health care, and retirement benefits. The transition to democracy meant a movement toward market economies, with deep structural changes, including the displacement of workers from their jobs. As a consequence, these economies faced a simultaneous rise in both unemployment and poverty, as shown in tables 1 and 2. In 1990, all these nations exhibited full employment. By 1993, unemployment had increased to 16 percent in countries like Bulgaria and Poland. Similar rates of unemployment would emerge by 2000 in the Baltic states and the Czech Republic. And poverty, which, according to official statistics, was nonexistent in the 1980s, had increased by the mid-1990s to rates in the range of 15 to 50 percent.

TABLE 1. Unemployment in Eastern Europe, 1989–2007 (percentage of the labor force)

Country	1989	1990	1991	1992	1993	1994	1995	2000	2007
Bulgaria	...	1.7	11.1	15.3	16.4	12.8	11.1	16.1	6.9
Estonia	0.6	0.6	1.5	3.7	6.6	7.6	9.7	8.8	4.7
Hungary	...	1.7	8.5	12.3	12.1	10.4	12.0	6.4	7.4
Latvia	...	...	...	2.3	5.8	6.5	6.6	16.3	6.0
Lithuania	...	...	0.3	3.5	3.5	4.5	7.3	13.6	4.3
Poland	...	6.5	11.8	13.6	16.4	16.0	14.9	14.4	9.6
Czech Republic	...	0.7	4.1	2.6	3.5	3.2	2.9	16.4	5.3
Romania	...	...	3	8.2	10.4	10.9	9.5	7.1	6.4

Source: International Labor Organization, Laborsta Internet Database (http://laborsta.ilo.org).

Note: ... = data not available.

TABLE 2. Poverty Rates in Eastern Europe, 1987–1988 and 1993–1995 (percentage of the total population)

Country	1987–1988	1993–1995
Bulgaria	2	15
Estonia	1	37
Hungary	1	4
Latvia	1	22
Lithuania	1	30
Poland	6	20
Czech Republic	0	1
Romania	6	59

Source: Maddison 2001.

The economic shock induced rapid policy responses, the most significant being the establishment of unemployment insurance, accompanied by incentives for early retirement and generous disability pensions. Unemployment insurance was established in the Czech Republic, Hungary, and Poland between 1988 and 1990 and was funded by contributions from employers, employees, and the state.

At the same time, there was heavy pressure for family support for displaced workers, and to maintain universal coverage in basic services. As a consequence, governments ran increasing deficits as a permanent, structural feature of public finance in the former socialist states, as shown in table 3. Even unemployment insurance, which in 1992 covered 65 percent of the unemployed, was cut because of fiscal constraints. Benefits were gradually reduced along with coverage, a process that continues up to the present, as shown in table 4. In 2007, only 30 percent of those unemployed were covered by insurance in the formerly socialist economies of Eastern Europe.

TABLE 3. Fiscal Balances in Eastern Europe, 1989–2007 (percentage of gross domestic product)

Country	1989	1990	1991	1992	1993	1994	1995	2000	2007
Bulgaria	...	−4.5	−3.1	−5.7	−11.3	−5.1	−5.1	−0.6	3.8
Estonia	...	...	5.2	0.9	−1.1	1.3	−0.8	0.2	2.7
Hungary	−1.9	−0.1	−4.9	−7.4	−6.3	−7.6	−3.7	−2.7	−4.9
Latvia	...	...	...	...	0.6	−1.9	−2.7	−2.2	0.9
Lithuania	...	...	...	...	−4.9	−4.7	−3.0	−2.8	−1.0
Poland	...	0.4	−3.8	−6.0	−4.0	−2.0	−2.7	−2.8	−2.0
Czech Republic	−3.8	0.5	−1.8	−1.8	0.2	−1.3	−0.9	−3.6	−2.8
Romania	8.2	1.0	1.9	−2.0	−0.1	−1.0	−2.5	−2.0	−2.3

Sources: IMF, various years, b; World Bank 2008.

Note: ... = data not available.

TABLE 4. Coverage of Unemployment Insurance in Eastern Europe, Selected Years (share of the unemployed receiving benefits)

Region or Country	1992	1998	2003	2006–2007
All Eastern Europe	65.0	44.3	32.4	30.1
Bulgaria	...	24.8	20.0	20.0
Estonia	56.4	59.3	50.0	44.0
Hungary	78.1	73.9	34.0	23.0
Latvia	...	44.0	44.0	50.0
Lithuania	...	41.1	13.2	22.0
Poland	79.0	23.1	19.0	13.0
Czech Republic	46.5	48.8	34.0	28.0
Romania	...	39.3	44.7	41.0

Sources: Riboud, Sánchez-Páramo, and Silva-Jáuregui 2002; Cazes and Nešporová 2007; Kogan, Gebel, and Noelke 2008.

Note: ... = data not available.

The period's generalized fiscal constraints created the conditions for changes in the provision of health care services and its funding. The system would decentralize, with public hospitals run by municipalities, and the funding would shift toward a contributory structure paid for by employers and employees. But the government continued performing the role of lender of last resort in financing the deficit. A timid process of privatizing health services began, but it was resisted by labor unions and by the general public, which expressed a strong preference for maintaining a universal safety net. The result was a hybrid system, with a predominance of public health and out-of-budget funding. In fact, the state financed 70 percent of total expenditures in health care, and the private share grew gradually, from 22 percent in 1995 to almost 30 percent as of 2006 (see table 5).

TABLE 5. Public Health Expenditures as a Percentage of Total Health Expenditures in Eastern Europe, 1995–2006

Year	Bulgaria	Estonia	Hungary	Latvia	Lithuania	Poland	Czech Republic	Romania	Eastern Europe
1995	73.1	89.8	84.0	66.3	74.2	72.9	90.9	70.3	77.7
1996	68.5	88.4	81.6	58.2	70.4	73.4	90.7	66.6	74.7
1997	69.7	89.2	81.3	55.8	72.5	72.0	90.3	69.5	75.0
1998	68.3	86.3	74.8	58.7	76.0	65.4	90.4	62.2	72.8
1999	64.7	81.0	72.4	58.0	74.9	71.1	90.5	72.6	73.2
2000	58.7	77.5	70.7	54.7	69.7	70.0	90.3	74.1	70.7
2001	55.4	78.6	69.0	51.2	72.6	71.9	89.8	73.7	70.3
2002	59.6	77.1	70.2	51.8	74.9	71.2	90.5	71.8	70.9
2003	60.8	77.1	71.3	52.4	76.0	69.9	89.8	72.0	71.2
2004	60.5	76.0	70.5	58.6	67.6	68.6	89.2	71.5	70.3
2005	60.6	76.9	70.8	60.5	67.3	69.3	88.6	70.3	70.5
2006	59.8	74.2	70.8	63.2	70.0	69.9	87.9	71.0	70.9

Source: World Health Organization Information System (http://www.who.int/whosis/en/index.html).

Pension reform became a very contentious issue in Eastern Europe and was resisted by vast segments of the population. That is why changes in the social security system were implemented only in the late 1990s. Partly because of the deterioration in the real value of pensions, and pressure from international lending institutions like the World Bank, a privatization process was started in the Czech Republic, Hungary, and Poland. The notion was to move from the old pay-as-you-go system to a three-pillar one. In the old system, benefits were defined and financed from the national budget. The reformed, privatized system would instead consist of three pillars: a basic pension paid for by the government, a second one paid for by mandatory contributions from employers and employees, and a third one consisting of additional voluntary contributions paid by workers. In Hungary and Poland, the second pillar was introduced in 1997, but the attempt to implement it in the Czech Republic failed; that country went back to the old pay-as-you go system. But even in the successful cases, contributions declined, together with the reduction in formal employment, and contributory evasion increased substantially. The expanding deficit had to be financed by the government. The policy outcome was a system with a high level of coverage because of the socialist inheritance (see table 6), but it was almost totally financed by the state (first pillar) and had a very low share of private funding, with low replacement rates as the result, as will be shown in a later section of this paper.

TABLE 6. Pension Coverage in Eastern Europe (percent)

Country	Year	Coverage Index = Contributors / Labor Force
Bulgaria	1994	64
Estonia	1995	76
Hungary	1996	77
Latvia	1995	60
Lithuania	1996	68
Poland	1995	85
Czech Republic	1994	55

Source: Palacios and Pallares-Millares 2000.

Note: Contributors are individuals who are actively contributing to the system. This measure is used in OECD reports.

Social Protection in the East Asian Economies

Transitions to democracy in East Asia, mostly in the 1980s, happened after extended periods of high economic growth and low unemployment.[7] East Asia's growth rate was double those of Eastern Europe and Latin America during their transitions to democracy in the 1980s. This allowed the region's nations to provide close to full employment, with unemployment rates in the 2–3 percent range, as shown in table 7. Social protection was not a high priority for these economies, except for workers in well-established modern corporations and for public-sector employees.

TABLE 7. Unemployment Rates in East Asia, 1985–2007
(percentage of the labor force)

Region or Country	1985	1990	1992	1993	1994	1995	1998	1999	2000	2005	2007
All East Asia	4.3	2.9	2.3	2.3	2.0	2.1	3.9	4.1	3.2	3.2	3.1
South Korea	4.0	2.4	2.4	2.8	2.4	2.0	6.8	6.3	4.4	3.7	3.2
Malaysia	6.9	5.1	3.7	3.0	...	3.1	3.2	3.4	3.0	3.5	3.2
Singapore	4.1	...	2.7	2.7	2.6	2.7	3.4	4.9	...	...	4.0
Thailand	3.7	2.2	1.4	1.5	1.3	1.1	3.4	3.0	2.4	1.4	1.2
Taiwan	2.9	1.7	1.5	1.5	1.6	1.8	2.7	2.9	3.0	4.1	3.9

Source: International Labor Organization, Laborsta Internet Database (http://laborsta.ilo.org).
Note: ... = data not available.

At the same time, the value system of Asian societies put much emphasis on the family as a key source of social protection. For example, recent data establish that in Japan 65 percent of retirees live in their children's homes. As a result, these countries show a relatively low level of social expenditures, although it is growing, as shown in table 8. For a large part of the population, families provide the basic social safety net.

TABLE 8. Social Public Spending as a Percentage of Gross Domestic Product in East Asia, 1990–2006

Year	South Korea	Malaysia	Singapore	Thailand	Taiwan	East Asia
1990	6.2	8.1	5.7	4.3	11.9	7.2
1995	8.3	9.7	5.1	5.3	13.0	8.3
1996	...	9.7	6.5	5.4	14.4	9.0
1997	...	10.1	4.6	6.5	14.1	8.8
1998	...	10.3	5.2	6.7	13.6	9.0
1999	...	10.8	5.3	6.8	13.4	9.1
2000	8.3	11.0	5.6	6.6	12.4	8.8
2001	9.0	12.3	8.2	7.8	14.4	10.3
2002	8.7	13.3	6.2	7.9	12.9	9.8
2003	8.3	12.4	5.9	8.2	13.4	9.6
2004	8.1	10.9	5.1	8.1	12.9	9.0
2005	10.1	10.2	4.5	7.1	12.8	8.9
2006	10.6	10.3	5.2	6.9	12.8	9.2

Sources: Asian Development Bank 2009; IMF, various years, a; OECD; Taiwan Statistical Data Book 2009.
Note: ... = data not available.

The cases of Singapore and Malaysia are particularly illustrative. The focus in those nations has been on the "workfare state" instead of the "welfare state." "The market and the family are sufficient, the state is not needed" is a simplistic way of describing this, but it does have a basis in culture and tradition.

However, during democratic transitions, the need for governments to legitimize power leads to increased social benefits and protection. The example of South Korea is particularly striking, as shown in table 8, where social public spending as a share of gross domestic product (GDP) has increased by 70 percent in the last fifteen years.

The so-called Asian financial crisis of 1997 forced governments in the region to accelerate an expansion of the social safety net that went beyond traditional boundaries. The impact of the crisis was particularly hard on economies like

South Korea, where in 1998, in seven months, unemployment shot up from 3 to 5 percent, and urban poverty from 7 to 21 percent.

Governments like South Korea and Taiwan reacted by establishing unemployment insurance.[8] Korea made this instrument one that would provide universal coverage, including part-time workers. This was complemented by a surge in transfer payments and by subsidies for families in distress.

A similar reaction can be observed for health care services. Again, South Korea and Taiwan established national public health systems that increased coverage and public funds gradually and systematically, as shown in table 9, whereby Korea's public expenditures for health care increased from 40 percent of the total to 55 percent in 2006. Those not covered used private hospitals and clinics, paying out-of-pocket expenses. In contrast, Malaysia and Singapore created capitalization funds, financed by mandatory contributions from employers and employees, and services were provided by public or private institutions competing through market mechanisms.[9]

TABLE 9. Public Health Expenditures as a Percentage of Total Health Expenditures in East Asia, 1995–2006

Year	South Korea	Malaysia	Singapore	Thailand	East Asia
1995	40.4	45.6	41.9	47	43.7
1996	43.1	48.2	40.8	47.2	44.8
1997	45.4	49.4	40.5	53.9	47.3
1998	50.0	50.9	49.1	54.8	51.2
1999	50.1	51.2	41.6	54.9	49.5
2000	50.7	52.4	36.8	56.1	49.0
2001	53.8	55.8	33.9	56.4	50.0
2002	52.5	55.4	30.1	63.5	50.4
2003	51.4	56.4	34.0	66.6	52.1
2004	52.2	50.0	30.0	64.7	49.2
2005	53.1	44.8	31.9	63.9	48.4
2006	55.1	45.2	33.6	64.4	49.6

Source: World Health Organization Information System (http://www.who.int/whosis/en/index.html).

A similar structure can be observed for social security. South Korea established a National Pension System that included the self-employed, whose goal, set in 1999, was to reach universal coverage. In fact, coverage increased from 5 percent in 1985 to 73 percent in 2000. Singapore and Malaysia developed private capitalization funds, similar to those of Mexico and Chile in the Latin American context.

Social Safety Nets in Latin America

Latin America's 1982 debt crisis and recent democratic transitions are the two most determining factors that have helped shape the region's current institutional framework for providing social services and social protection.[10] The debt crisis forced deep macroeconomic reforms in most Latin American economies. Both the intensity of the financial crisis and the tough adjustment mechanism implemented to deal with it led to a deep recession and high unemployment in most countries. Unemployment was particularly severe in Chile, Colombia, Uruguay, and Venezuela, with rates as high as 17 percent, as shown in table 10. A natural consequence was a sharp increase in poverty, to rates as high as 50 percent, as shown in table 11. This only reinforced what can be described as the Achilles' heel of Latin American development—that is, profound income inequality that did not seem to improve significantly, even after the financial crisis was over.

TABLE 10. Unemployment Rates in Latin America, 1985–2007 (percentage of the labor force)

Region or Country	1985	1990	1995	2000	2005	2007
Latin America average	10.0	7.4	8.8	10.4	10.0	8.0
Argentina	6.1	7.4	17.5	15.1	11.6	8.5
Brazil	5.3	4.3	4.6	7.1	9.8	9.3
Chile	17.2	9.2	7.4	9.7	9.2	7.1
Colombia	13.9	10.5	8.8	17.3	13.9	11.4
Costa Rica	6.7	5.4	5.7	5.3	6.9	4.8
Mexico	4.4	2.7	6.2	3.4	4.7	4.8
Peru	10.1	8.3	8.2	8.5	9.6	8.4
Uruguay	13.1	8.5	10.3	13.6	12.2	9.6
Venezuela	13.1	10.4	10.3	13.9	12.4	8.4

Source: International Labor Organization, Laborsta Internet Database (http://laborsta.ilo.org).

TABLE 11. Poverty Rates in Latin America, 1987–2006 (percentage of the total population)

Country	1987	1990	2000	2006
Argentina	32.3[a]	33.7	28.9	26.9
Brazil	37.8	40.7	33.6[b]	25.1
Chile	45.1	38.6	20.2	13.7
Colombia	...	52.5[c]	55.0	45.1
Costa Rica	32.8	31.0	23.1	22.8
Mexico	53.5[d]	53.1[e]	53.6	42.6
Peru	...	...	48.4	44.5
Uruguay	35.6	29.7	17.8	27.5
Venezuela	...	...	46.3	36.3

Source: Socioeconomic Database for Latin America and the Caribbean (http://www.depeco.econo.unlp.edu.ar/sedlac/eng/statistics.php).

Note: ... = data not available.

[a]Year is 1988, [b]year is 2001, [c]year is 1991, [d]year is 1989, [e]year is 1992.

Historically, social protection in Latin America has been highly segmented, with good coverage for those in the civil service, teachers, the military, and employees of large corporations. Funds were mainly provided by the government budget, plus limited contributions by employers and employees. Workers in the informal sector or holding temporary jobs were not covered.

Repeated financial shocks in the 1980s and 1990s forced a contraction in social expenditures. This fact tended to lower the replacement rates in public pensions and reduced the quality and efficacy of public health providers. Several forms of rationing emerged, such as long and extended waiting lists for medical care, and an increasing trend by medical doctors in private practice to use public hospital facilities to respond to the increased demand for health services.

An immediate response to the crisis took the form of increased family allowances, nutrition and food programs, and later the more successful conditional cash transfers. These cash transfers became very popular in the late 1990s, and their characteristics have been widely described in the relevant literature.[11] The programs were most significant in Brazil and Mexico but less so in Chile, Costa Rica, the Dominican Republic, Ecuador, Honduras, and Jamaica.

An additional reaction to the repeated external shocks was to establish or improve unemployment insurance. This took time, and coverage has been very low, as illustrated in table 12. Fewer than 20 percent of those unemployed are covered. In most countries, coverage is below 10 percent.

However, the most significant structural reforms occurred in health care and pensions in Latin America. The general trend was toward privatizing these services, with the exception of Brazil, Costa Rica, and Uruguay. The so-called three-pillar model proposed by the international financial institutions was fully implemented in countries like Chile, but less so in Colombia, Peru, and others. It is interesting to note that those nations that have maintained a publicly funded system also exhibit higher rates of coverage. Of those privatized, only Chile (and only recently) has reached a similar level of coverage, about 60 percent. These data are shown in table 13.

TABLE 12. Coverage of Unemployment Insurance in Latin America, 1998 and 2004 (share of the unemployed receiving benefits)

Country	1998	2004
Argentina	5.5	4.1
Brazil	6.2	7.5
Chile	...	19.7[a]
Ecuador	4.5	2.8
Uruguay	17.0	8.7

Sources: Velasquez 2003; for Chile, Superintendencia de Pensiones (http://www.safp.cl).

Note: [a]year is 2008; ... = data not available.

TABLE 13. Coverage Rates of Pensions in Latin America, 1990s and 2000s (contributors as a percentage of the labor force)

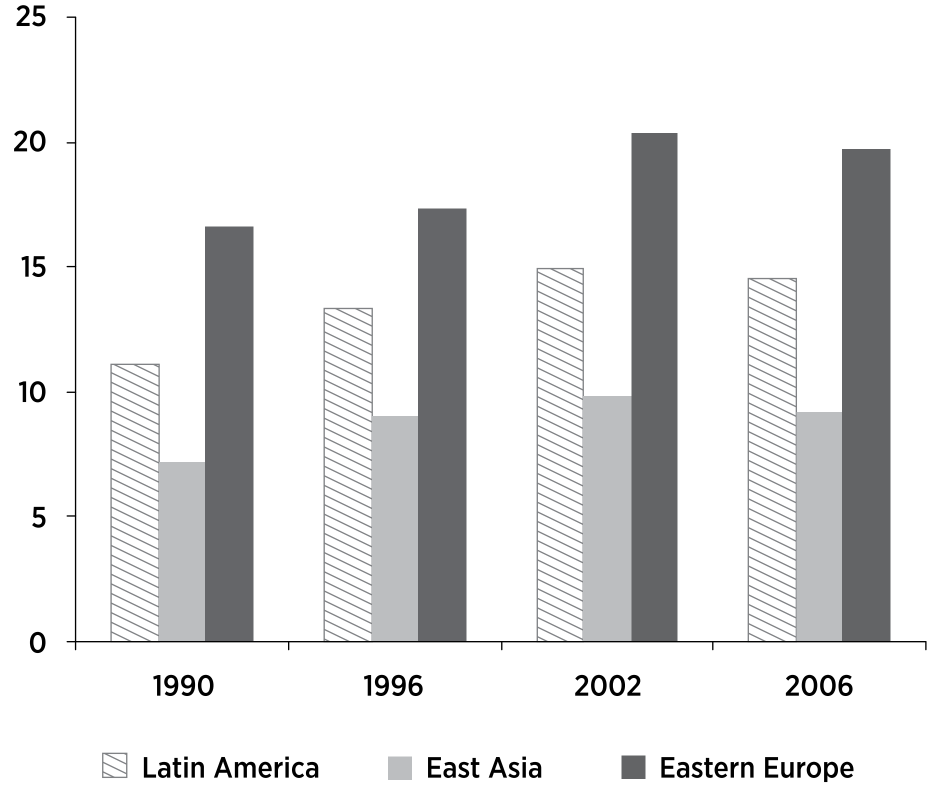
Country	1990s	2000s
Argentina	41.4 (1995)	37.7 (2005)
Brazil	47.7 (1995)	48.1 (2006)
Chile	58.6 (1995)	62.7 (2006)
Colombia	25.3 (1996)	31.8 (2006)
Costa Rica	67.5 (1995)	62.7 (2006)
Mexico	34.3 (1996)	35.9 (2006)
Peru	10.8 (1998)	14.0 (2006)
Uruguay	55.5 (1995)	60.9 (2006)
Venezuela	36.3 (1995)	35.3 (2006)

Source: Rofman, Lucchetti, and Ourens 2008.

Convergence and New Social Demands After the Crisis

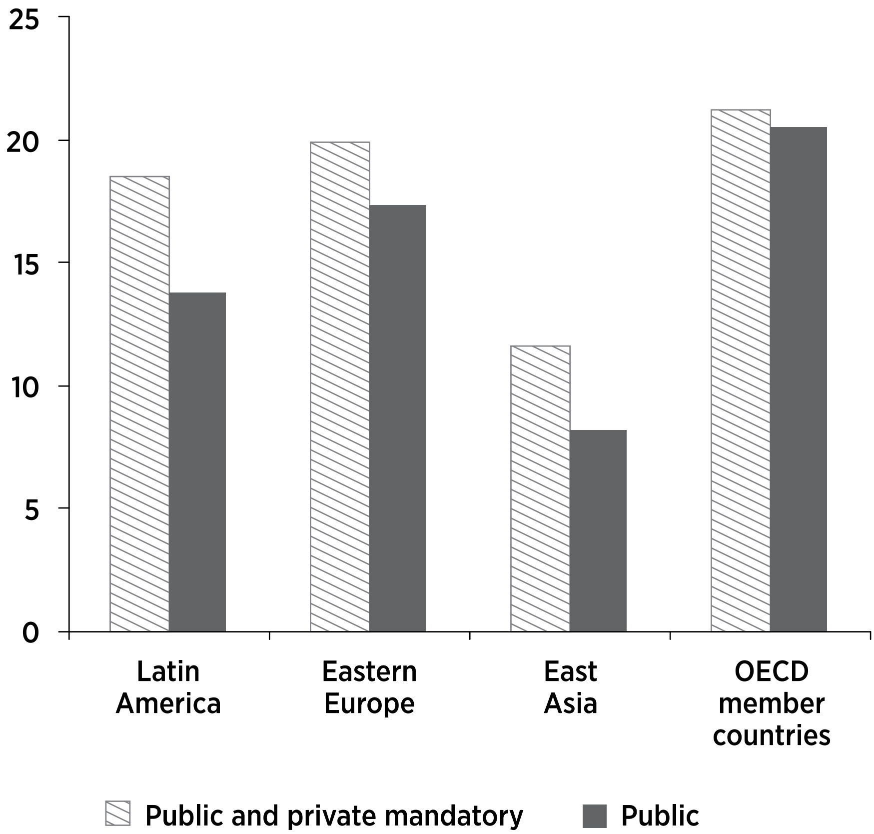
The comparative analysis of social safety nets in middle-income countries given above shows some degree of convergence in policy instruments and in the amount of resources used for social protection. In fact, total social expenditures (public and private), along with the tax burdens to finance them, do not differ much for Eastern Europe and Latin America, although they are still lower than in economies that belong to the Organisation for Economic Co-operation and Development (OECD), as seen in figures 3 and 4. Conversely, the East Asian countries rely much more on personal savings and family structures as the key component of their social safety nets.

FIGURE 3. Public Social Expenditures as a Percentage of Gross Domestic Product, 1990–2006



Source: IMF, various years, b.

FIGURE 4. Total Social Expenditures (Public and Private Mandatory) as a Percentage of Gross Domestic Product, 2006



Sources: IMF, various years, b; World Health Organization Information System (http://www.who.int/whosis/en/index.html); UNESCO Institute for Statistics (http://www.uis.unesco.org); OECD Stat Extracts (http://stats.oecd.org).

Institutions in middle-income countries are still very different, given their past histories. This is particularly true for the former communist countries, where the transition is ongoing. Nevertheless, there is a certain convergence toward mixed public–private systems, although the role of one or the other is still in a state of flux in some of these countries. The level of public provision of basic social services stands at about 70 percent of the total in Eastern Europe, 60 percent in Latin America, and 50 percent in East Asia.

There are shared deficits in social protection within this group of middle-income countries. Coverage of social security is low in East Asia, at still about 30 percent of the labor force, between 40 and 60 percent in Latin America, and closer to 70 percent in Eastern Europe. That is still significantly lower than the 80 to 90 percent of the population eligible for pensions in the OECD economies.

The coverage of unemployment compensation is another deficit in social safety nets. Only between 5 and 20 percent of those unemployed are covered in Latin America, and about 25 percent in East Asia. The case of Eastern Europe is interesting because coverage for unemployment insurance was very high immediately after the collapse of the centrally planned economies. In Hungary in the early 1990s, 74 percent of the unemployed had access to benefits, but this has now been reduced to 37 percent—a clear indication of the shrinking capacity of the state to finance the inherited socialist welfare system. In the OECD economies, however, unemployment insurance covers 90 percent of the unemployed.

The high priority of reducing the two social deficits mentioned above is obvious. When unemployment increases substantially and threatens to stay there for several years, as in the current global crisis, unemployment compensation becomes a critical instrument of social protection.

Fully financed pension funds are equally critical. When middle-aged employees who have lost their jobs in the current recession realize that the episode could extend well beyond six months and perhaps one or two years, early retirement becomes a real possibility. That, plus the impact of the aging population, will put enormous financial stress on the social security system.

These are just two illustrations of the sources of the political and social pressures to strengthen the existing social safety nets prevalent in middle-income countries. The longer the recovery phase of the current global crisis lasts, the higher will be the pressure. These and similar topics will be increasingly in the public debate in the near future. Whatever lessons can be extracted from past and current experiences are, therefore, highly valuable.

Lessons Learned

The experiences described above can be distilled into seven principal lessons. These lessons range from the influence of sociopolitical constraints in the path likely to be adopted when the social safety net is transformed to take account of the current crisis, to practical considerations that might be useful to policy makers.

Democratic Transitions Open the Way for Expanding Social Protection

The first lesson is that democratic transitions open the way for an expansion of public expenditures on social protection. Throughout the 1990s, the Latin American and Eastern European economies increased their public social expenditures by 3 percent of GDP, and the East Asian economies by 2 percent, as shown in figure 3 above. When compared with the expenditures in the OECD economies, these amounts are still low; the OECD countries spent 12 percentage points of GDP more than East Asian economies, 6 points above the average for Latin America, and 3 points more than the Eastern European economies.

The differences with the OECD economies decrease significantly when total social expenditures are compared, meaning public plus private expenses. In that case, the percentage for Eastern Europe was 20 percent of GDP spent in the social sector, compared with 21 percent for the OECD countries. For Latin America, the figure was 18.5 percent. These differences are not substantial, as indicated in figure 4 above.

What these numbers reflect is the effort by the Eastern European and Latin American economies to diversify the sources of funding for their social safety nets. They now include various forms of mandatory private savings to finance health care, pensions, and unemployment insurance, in the face of binding fiscal constraints.

The situation for the East Asian countries is quite different, as also shown in figure 4 above. The public resources in East Asia are well below OECD averages. This reflects the heavy reliance on private savings and familial networks in East Asia as a very significant component of social protection. It confirms the relatively minor role that domestic consumption plays as a factor in growth, contributing to so-called global imbalances.

Good Macroeconomics Pays

The second lesson concerns the fact that the capacity of middle-income countries to maintain and strengthen social safety nets depends critically on sound and solid macroeconomic management, sustained throughout both good and bad times. The contrasting experiences of the Eastern European and Latin American economies in recent years are stunning—as accentuated by the current global financial crisis.

The Eastern European economies have overspent and run significant current account and budget deficits, and have faced high unemployment, reaching double digits in 2009. As a consequence, the region's governments have been forced to ration the scarce public financing that sustains the social safety net. The coverage of unemployment insurance has been reduced from 66 percent of those unemployed in 1992 to 30 percent currently. Replacement rates have also suffered, now being equivalent to only one-fourth of salaries paid during employment. Public funding for the National Health System has decreased as a share of total health expenditures, from 78 percent in 1995 to less than 70 percent more recently, the rest representing a de facto "shadow privatization" of health care.

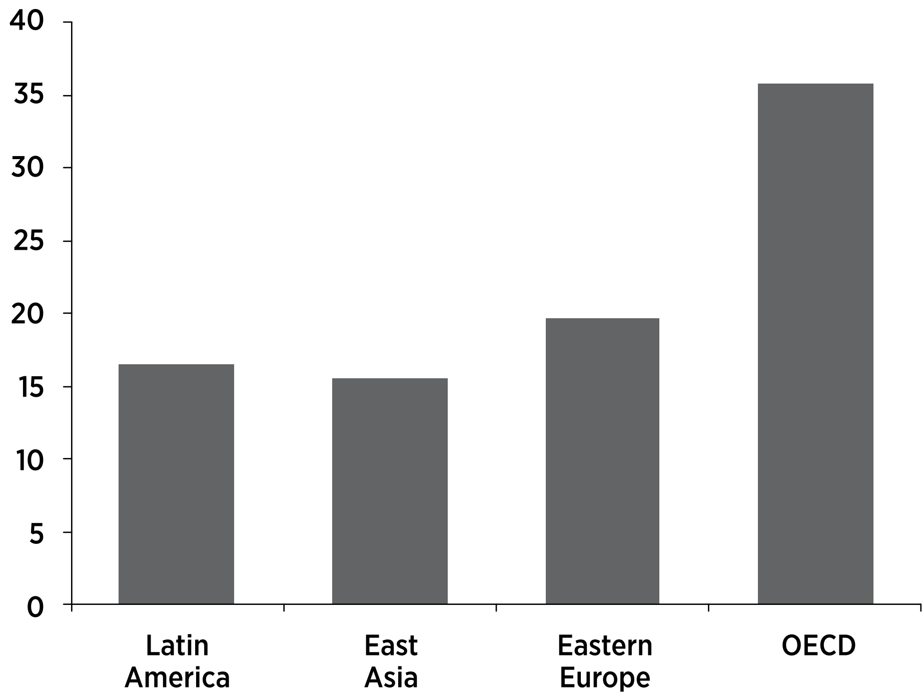
The Latin American economies, conversely, learned their lesson after the repeated financial shocks of the 1980s and 1990s. Therefore, these economies have been able to face the current global financial crisis with twin surpluses, in the current account and in the budget, rather than the twin deficits observed in Eastern Europe and in previous similar episodes in Latin America. A high level of international reserves and of public-sector savings have made it possible to finance significant repeated fiscal stimulus efforts without reducing social expenditures. In fact, in several countries, public funding for the social safety net has been increasing instead of retrenching as part of a continuous process during the last decade, to strengthen the social equity component of development strategies.[12]

The lesson is that the strong fiscal position of Latin American economies offers the opportunity to continue increasing coverage in basic social services, providing additional funding for the solidarity component of the health care, social security, and unemployment programs, and strengthening the rather weak efforts to improve the quality of education and on-the-job training of the labor force.

Solving the "Raise Taxes" Dilemma?

The third lesson is that an obvious response to the need to increase the coverage and quality of social programs in middle-income countries would be to increase taxes, but that this presents a dilemma. In fact, when the tax burdens of middle-income and OECD economies are compared, the differences are still quite large, as shown in figure 5. The average tax revenue of 36 percent of GDP in the OECD economies is almost double those observed in Latin America and Eastern Europe. Why have the latter not moved toward OECD levels?

FIGURE 5. Tax Revenues as a Percentage of Gross Domestic Product, 2007



Sources: World Bank 2007; Asian Development Bank 2009; CepalStat (http://www.eclac.org/estadisticas/bases/).

In middle-income economies, there is always an excuse for not increasing taxes. One line of argument stresses that the political party system is weak and highly fragmented, thus making it very difficult to build stable coalitions that would develop a longer-term view of what is needed to reduce economic insecurity and improve the social safety net. In principle, most political parties might agree on the final objective—raise taxes for a better social safety net—but not in paying the political cost involved in supporting legislation that would increase taxes. Latin America is a good example here.

The other line of argument looks at the need to remain competitive in the globalized economy. This argument has been advanced and, in several cases, put in practice by several Eastern European states. The objective has been to attract investment and eventually induce Western European companies to relocate to Eastern Europe. Their competitive advantage would develop through lower taxes and relatively lower wages. The Baltic states have in fact radically lowered taxation. And this type of policy has been implemented in Slovakia, through a low flat tax.

In East Asia, the argument for low taxes is even simpler. The engine of growth is exports. Low taxes have proven to be the right approach to achieve very high growth rates for the region's economies in the last three decades. To maintain their competitive advantage in exports, three conditions must be met: high-quality human resources, low taxes, and low wages. As real wages increase, the burden on lower taxes and the quality of education becomes even more important for sustaining dynamic export growth, according to the East Asian view.

The East Asian argument for low taxes is valid if accompanied by sound macroeconomic management and sustained rapid growth in the economy. Under those conditions, high growth rates are an automatic mechanism for the government to collect higher tax revenues, even without increasing tax rates. These resources can be used to gradually expand a social safety net, as economies like South Korea and Taiwan are successfully doing.

However, if growth is not high or persistent, public finances become the victim of financial volatility. Given existing social entitlements, there is constant pressure on the budget for higher expenditures and, as a consequence, there are recurrent budget deficits. The way out is simple: either higher inflation, or a systematic deterioration in the quality and coverage of social services. This has been the story in Latin America for decades and, as we have seen, more recently in Eastern Europe. The alternative to muddling through has been to find ways so that companies and employees share more of the costs, in the form of mandatory contributions for social services, instead of attempting (and generally failing) to increase tax rates. The movement in this direction has been clear in Latin America, where privately funded (by way of mandatory contributions) social services already represent one-fourth of total social expenditures. In East Asia, the share is 30 percent, whereas the former socialist economies in Eastern Europe still finance only 10 percent of their total social expenditures with private funding.

Shortcomings of the Populist Solution

The fourth lesson is that the populist answer is a third way out of the contradiction between the pressure for universal coverage of social services and the resistance to raising taxes—but one with shortcomings. A reform of a nation's constitution may be proposed to guarantee, as basic social and political rights, universal access to social services. This has been the path pursued by legislatures in countries such as Brazil and Colombia.[13]

But as has long been argued, the only way that such universal guarantees will become a reality is in the context of economies capable of sustaining permanent full employment.[14] This implies significant and stable growth rates for the economy, which in turn will generate sufficient tax revenues to finance the social safety net. The classical example, of course, is the model implemented by the Scandinavian countries in the last several decades, where advanced social welfare systems have coexisted with high growth and low unemployment. But the reality of the developing middle-income economies is far from that in high-income Scandinavia. Economic cycles in these middle-income countries not only affect growth rates but also introduce high volatility in fiscal revenues, levels of employment, and inflation.

When this reality is contrasted with the universal social rights guaranteed by a nation's constitution, there are two possible accommodations: to finance what you can, and look the other way when constitutional norms are not observed; or to go to the constitutional court, as in Colombia, and ask the court to mandate the executive to increase expenditures until universal coverage is achieved.

Either of these "solutions" would imply extended and high litigation costs, because constitutional "rights" are not respected in practice. In the end, some form of rationing access to social services will be required—through queuing, long waiting lists, or a very low quality of services. Several middle-income countries suffer from some of these unintended consequences of constitutional social rights that cannot be fulfilled.

The Pluses and Minuses of Privatization

The fifth lesson is that privatization has had a strong ideological connotation in middle-income countries, with both pluses and minuses. The partial privatization of social services in Eastern European economies in the 1990s was a very difficult process. It was resisted by all beneficiaries of the old system (the civil service, employees of large state-owned companies, the labor unions—in short, the so-called insiders in the socialist regime). It was promoted by technocrats and the international financial institutions. And it was looked upon with suspicion by progressive and social democratic parties elsewhere. The resulting institutional outcome has been hybrid systems, in which governments often continue performing the role of lenders of last resort whenever the private sector proves incapable of financing the expected benefits.

There are other cases, mostly in East Asia (for instance, Singapore and Malaysia), and in Latin America (Chile and Mexico), where full privatization of at least one basic service, usually social security, has been proposed and put in practice. This means that mandatory individual savings accounts constitute the basic pillar that determines the value of pensions, equivalent to the accumulated individual savings in the life cycle. Usually, a complementary pillar is added, funded by the government for disability pensions and to cover extremely poor people.

It is beyond the scope of this study to provide answers to the numerous questions that arise in daily political discussions about the advantages and disadvantages of privately versus publicly provided social services. The recent passionate discussion of health care insurance reform with a public option in the U.S. Congress proves this point beyond doubt.

Here, I make just three observations from experience, particularly in the Latin American context, concerning the strong and weak points of the privatization process in the area of pensions and health care. First, there is no doubt that when privatization is complemented by a strong government-financed "first pillar," the total resources available for social protection will increase. The coverage and value of pensions will rise, and the quality of health care will improve.

What privatization does not do is self-regulate, in terms of cost controls for the services provided. Again, the experience of the United States, with its private health care system, resonates as familiar in some middle-income countries' experience. Peter Peterson has recently reminded us that the cost per capita of the equivalent health care services privately provided in the United States is double the cost in other developed economies, where public-sector providers predominate.[15]

The second point that must be made, in the context of developing economies with a high concentration of income, is that higher-income groups can access higher-cost, higher-quality privately provided health care, and low-income groups in practice only have access to public hospitals and public preventive care.[16]

The third lesson learned from experience is that a satisfactory solution, even after partial privatization, is to move in the direction of compensating for the unequal distribution implicit in the system by complementing it with a strong solidarity fund financed from tax revenues, and providing incentives for additional voluntary contributions that would allow ever-wider segments of the population to access better-quality, more comprehensive providers of social services.

The problem of exploding costs, particularly for privately provided health care services, must be dealt with by adequate regulation and/or enhanced competition. The presence of state-administered providers competing with private-sector providers might prove to be an efficient mechanism to lower costs and extend coverage.

A final comment on the institutional structure established to provide key social services and safety nets is that it is essential to understand that an overhaul of the system, in the direction either of a larger state role or privatization, is to a large extent a once-and-for-all option. The political cost of such emblematic institutional changes always tends to be high in a democracy. Moreover, once the institutions are designed or reformed, changing them becomes extremely difficult. Vested interests tend to impede further adjustment. Errors in the original design will tend to persist.

If private-sector providers predominate, no state-administered institution will be welcome, either as a regulator or provider. The opposite is also true. When the public sector is the main provider, the beneficiaries of the system will see privatization as a major threat to fairness and social inclusion. Throughout the 1980s and 1990s, public opinion in several countries in Eastern Europe and certainly in Latin America reflected this type of reaction.

Do Not Attempt to Copy Other "Models"

The sixth lesson is, in short, to not to attempt copying other "models." As suggested in the previous section, the discussion about which is the best set of institutions to provide social protection, with a high level of coverage of basic social services at a reasonable cost, will be open for a long time to come in middle-income economies, and perhaps even in some industrialized countries.

In planning reforms of social protection, it is wise to recall that there will be a higher probability of success if “path dependence” is taken into account. People do have a priori preferences for the public or private provision of health care, and for pay-as-you-go or mandatory individual capitalization accounts for retirement benefits. But once a system is established, reforms that are conceived within the existing institutional framework will probably have a higher chance of success. The cost of overcoming resistance in trying to install a whole different system is likely to outweigh the benefits. The real issue, then, is how to significantly improve what already exists, and what few strategic changes would be required to improve the coverage and quality of services and to reduce costs.

More Equality Is the Basis for Strong Democracies

The seventh and final lesson is that more equality is the basis for strong democracies. High levels of inequality breed discontent, fragile democracies, and eventually populism and “delegative democracy.” In a “delegative democracy,” those in government attempt to concentrate power in the executive, often including indefinite reelection terms for the president and a devaluing of the roles of Congress and the judiciary. This is offered as the only way to carry forward radical changes that would reduce inequality and, eventually, create a new social order.

It is not a mere coincidence that this phenomenon tends to appear with regularity in areas of the world such as Latin America. Table 14 compares income inequality in the three geographical areas this report deals with. Latin America is the region with the most income inequality, as measured by the Gini coefficients given in the table. Eastern Europe is less unequal, a legacy of its former socialist regimes, and East Asia exhibits coefficients similar to those in the OECD economies.

TABLE 14. The Inequality of Income, 1980s, 1990s, and 2000s (Gini Index)

Region and Country	1980s	1990s	2000s
Latin America			
Brazil	59	60	56
Chile	56	55	52
Costa Rica	...	44	49
Uruguay	42	42	46
East Asia			
South Korea	34.5	33.5	31.6
Singapore	38.3	44.3	48.1
Taiwan	29.0	31.5	33.9
Eastern Europe			
Hungary	22	24	28
Poland	28	32	37
Czech Republic	20	22	26

Source: UNU-WIDER World Income Inequality Database, Version 2.0c, May 2008 (www.wider.unu.edu/research/Database/en_GB/database/).

Note: The Gini Index is a number between 0 and 100, where 0 corresponds with perfect equality (where everyone has the same income) and 100 corresponds with perfect inequality. ... = data not available.

There are constraints to reducing income inequality in a representative democracy. Those who earn more de facto acquire substantial power to influence decisions and to prevent policy outcomes contrary to their interests. A clear example is the enormous difficulty of persuading national legislatures under democratic rules to increase taxes sufficiently to have a significant redistributive effect on incomes from the rich and upper middle class to the rest of the population. Latin America has abundant experience with well-intentioned progressive democracies where presidents fail time and again in raising taxes to reduce income inequality and extend social protection.

But this argument must be qualified, first because several middle-income countries have been able to implement significant tax reforms, and, second because well-focused and well-designed social policies can reduce income inequality.[17] And yet additional progress in this area will not be easy. What can be done about it? A radical solution would be to redistribute assets using massive nationalization, price controls, and other forms of direct state intervention. That road has been frequently tried in the past, with disastrous results.

The answer for middle-income democracies is to concentrate as many resources as possible not only on social safety nets but also on heavily investing in human capital. This implies improving opportunities, mainly access to good jobs, for those left behind by the modernization of open market economies.

For the future, the relevant question is what will be most meaningful for people as an indicator of their own welfare. This is part of a discussion that has been going on in the Northern European countries for quite a few years. In their context, the topic became relevant not because they exhibited high income inequality in a static sense; in fact, they exhibited the lowest Gini coefficients, particularly Scandinavia. The concern emerged because of globalization and its effects. It is generally recognized that globalization tends to increase income inequality, among other factors, because it puts a premium on the highly skilled and penalizes people with low levels of education. Skills are what define the competitive outcome in a globalized economy.

The Scandinavian reply to this challenge has been that what really matters for globalized democracies is what happens to people and households throughout their life cycles—whether they experienced sufficient upward mobility and gradually realized expectations of higher levels of welfare for the family and their children. From a social policy point of view, this implies refocusing social policies from social assistance toward high-quality education, active labor market policies, opening job opportunities for women and young adults from poor families, retraining low-skilled workers, and promoting innovation and entrepreneurship—in short, guiding a transition from a welfare state to a workfare state.

It remains to be seen whether this new focus translates into a persuasive political discourse for middle-income countries, where initial income inequality breeds impatience and invites populist politicians to offer always-tempting "shortcuts" to development and an equitable society. The difference in political outcomes will depend on the quality and maturity of political leadership, a commodity not necessarily abundant in many not-yet-strong democracies.

Conclusions

This comparative study has several conclusions:

- The more open the economy and the more democratic the political system, the higher the pressure to increase expenditures in the social sector.
- Good macroeconomic policies pay. They allow countries to implement countercyclical social policies during downturns, as many Latin American economies have done during the current global financial crisis. Bad macroeconomic policies get governments into trouble and the social safety net deteriorates, with potentially severe political consequences. Recently, this has been the case with the Eastern European economies.
- Pressures to maintain full coverage of social services, or to expand coverage when significant segments of the population are not covered, will persist. This will occur even when fiscal deficits and the public debt are getting beyond control. At that point, governments should respond by opening up to several alternatives.
- One alternative for governments is to implement a tax increase to finance the deficit. The political economy of this alternative will always be problematic in democracies that are not yet mature. Parliamentary majorities to augment the tax burden will be possible only under exceptional circumstances.

- A second alternative for governments is to rely more on mandatory or voluntary contributions from employers and employees to finance a part of the social safety net. This usually involves some degree of private-sector participation as suppliers of health care, or as administrators of private pension funds.

This study has also identified several critical issues that still must be addressed:

- How do the public and private sectors interact in the provision of services? Will they complement each other with some redistributive mechanism within the mixed system so that the beneficiaries of one or the other have access to similar services of comparable quality, whether they take the public or private option? Or will they just coexist, with the private sector providing high-quality services to high-income groups, and an underfinanced public sector providing services to the rest of the population?

- The challenge will be for governments to be able to induce enough competition as a way of reducing costs, or directly regulating costs when oligopolistic structures prevail in the private sector.

- On the public-sector side, deep reform will be required to increase efficiency, reduce long waiting lists, and improve the quality of services.

To resolve these critical issues, all the persuasive powers of the executive will be required because, once a set of institutions has been established, special interests will certainly try to block any changes, particularly when they involve privatization. The experience of the Eastern European and Latin American countries reinforces this conclusion.

When social safety nets must be strengthened in a democratic environment, it is more efficient to undertake reforms within the existing institutional framework. If the system is predominantly public, the problem of inadequate funding and low quality of services must be tackled. If the system is predominantly private, the challenge is to reduce costs through more competition, including a public option.

Democracies, to mature, require more and not less equality. The problem is that globalization pushes in the opposite direction: by putting a premium on high skills in order to compete with others, it increases income inequality between the highly skilled minority and the rest. Reducing economic insecurity with an expanded welfare state is not sufficient. A transition from a welfare state to a workfare state will be needed, with much emphasis on providing higher skills for the labor force as a whole and improved access to the labor market for women and low-income youth. Better incentives for entrepreneurship and innovation to expand job creation should also be a key component of the new social policies. Only then can social policies move beyond their role as instruments of social protection to be considered key factors of production.

Appendix: The Incidence of Social Policies and the Tax System in Chile

A powerful instrument for redistributing income and welfare has been that of public social expenditures. The data given in table A1 show that public social expenditures almost tripled in Chile in the period 1990–2006, with expenditures in public health growing 400 percent; in education, 370 percent; and resources for social protection (defined as social security plus social assistance) nearly doubling. The expenditures were highly focused on low-income groups, as shown in table A2. An average of 50 percent of total expenditures benefited the lower 20 percent of the population, and close to 80 percent reached the lower 40 percent (quintiles 1 and 2).

TABLE A1. Increase of Social Public Spending in Chile, 1990–2006 (Index: 1990 = 100)

Type of Spending	1990	1996	2000	2006
All public spending	100	153.3	193.5	248.2
Education	100	195.1	278.9	367.3
Health	100	203.1	266.0	401.1
Social protection	100	131.7	155.6	184.2

Source: Larrañaga 2009.

TABLE A2. Incidence of Social Public Spending in Chile, 2006 (percent)

Type of Spending	Quintile I	Quintile II	Quintile III	Quintile IV	Quintile V
Overall incidence	43	28	18	7	4
Health	55	33	18	4	–10
Education	35	27	19	9	10
Chile Solidario	58	23	13	5	1

Source: ECLAC 2007.

Note: Health = health subsidy, education = education subsidy, and Chile Solidario = conditional cash transfer program.

How much did these social programs influence the distributive outcome? In table A3, we can see that a high initial Gini coefficient of 0.52 is reduced to 0.45 when the redistributive effect of taxes, social programs, and cash transfers is taken into account. It is still on the high side, but it shows a significant improvement with respect to the original distribution of monetary income in Chile.

TABLE A3. Gini Index, Chile (2006)

Aspect	Change in Gini Index
Gini Index before taxes, social spending, and cash transfers	0.522
Social spending	0.440
Health and education	0.453
Education	0.479
Health	0.493
Cash transfers	0.507
Taxes	0.530
Value-added tax	0.545
Income tax	0.507
Other taxes	0.523
Gini Index after taxes, social spending, and cash transfers	0.448

Sources: ECLAC 2007; Agostini 2009.

Note: The Gini Index is a number between 0 and 100, where 0 corresponds with perfect equality (where everyone has the same income) and 100 corresponds with perfect inequality.

Notes

Fernando Sossdorf and Carolina Mendez of CIEPLAN provided valuable research assistance for this report.

1 The old-age pension replacement rate is a measure of how effectively a pension system provides income during retirement to replace earnings that were the main source of income before retirement. In the case of unemployment insurance, the replacement rate is a measure of how effectively an unemployment insurance system provides income during a job loss to replace wages.

2 For detailed data on each country discussed here, see the website of the Corporación de Estudios para Latinoamérica, http://cieplan.org.

3 Reinhart and Rogoff 2009.

4 Guha, Strauss, and Giles 2009.

5 The analysis in this section is based on a review of the recent economic literature on the subject. An outstanding contribution that has significantly helped shape my views on the subject is Haggard and Kaufman 2008. Other sources are Glatzer and Rueschmeyer 2005; Garret and Nickerson 2005; Esping-Andersen 2002; Hemerijck 2002; Gilbert and Van Voorhis 2003; Gilbert 2004; and several reports by the OECD and the World Bank.

6 On Eastern Europe, see, among others, Orenstein and Haas 2005; Kapstein and Mandelbaum 1997; Kramer 1997; Connor 1997; Kogan, Gebel, and Noelke 2008; Cazes and Nešporová 2007; and Haggard and Kaufman 2008.

7 On East Asia, see Haggard and Kaufman 2008; Song and Hong 2005; Esping-Andersen 1999; Rose and Shiratori 1986; Midgley and Leung Tang 2009; and Ramesh 2007.

8 In South Korea, unemployment insurance was established in 1995 and was expanded in 1998. In Taiwan, it was established in 1999.

9 These capitalization funds were created in 1951 in Malaysia (Employees Provident Fund) and in Singapore in 1955.

10 Useful references for Latin America include Huber 2005; Bourguignon and Walton 2007; Szèkely 2007; Birdsall, de la Torre, and Menezes 2008; Cardoso and Foxley 2009; Castelar, Bonelli, and Abreu de Pessoa 2009; ECLAC 2006, 2007; Levy 2008; Pages, Gaelle, and Scarpetta 2009; Rofman, Luchetti, and Ourens 2008; and World Bank 2009.

11 See Levy 2006, 2008; Handa and Davis 2006; and World Bank 2009.

12 A good example is the Michelle Bachelet government in Chile, which has managed to implement an effective countercyclical social policy during the current recession. Public social expenditures have increased at an annual rate of 11 percent since the crisis started in 2007.

13 In Brazil, the new Constitution of 1988 defined generous entitlements as legal rights. This led to an abrupt increase in public expenditures and inflation. The reformed Constitution in Colombia in 1991 had a similar effect. See Castelar, Bonelli, and Abreu de Pessoa 2009; and Steiner, Clavijo, and Salazar 2009.

14 Esping-Andersen 1999, 2002.

15 Peterson 2009.

16 In the case of Chile, the private and public health care systems coexist. They are financed by individual mandatory contributions (about 10 percent of salaries) and by the state. Higher-income groups' contributions allow them to choose private health care. In fact, 45 percent of families in the highest-income quintile have access to private health care, whereas only 2 percent with the lower 20 percent of income can afford private health services. And 92 percent in this lower quintile go to public hospitals and public health facilities.

17 See the appendix for the case of Chile.

References

Agostini, C. 2009. Política Tributaria. Paper presented at Corporación de Estudios para Latinoamérica, Santiago.

Asian Development Bank. 2009. *Key Indicators for Asia and the Pacific 2009.* Manila: Asian Development Bank.

Birdsall, N., A. de la Torre, and R. Menezes. 2007. *Fair Growth: Economic Policies for Latin America's Poor and Middle-Income Majority.* Washington, D.C.: Brookings Institution Press.

Bourguignon, F., and M. Walton. 2007. "Is Greater Equity Necessary for Higher Long-Term Growth in Latin America?" In *Economic Growth with Equity: Challenges for Latin America*, ed. R. Ffrench Davis and J. L. Machinea. New York: Palgrave Macmillan.

Cardoso, F., and A. Foxley, eds. 2009. *A medio camino: Nuevos desafíos de la democracia y del desarrollo en América Latina*. Santiago: Uqbar Editores.

Castelar, A., R. Bonelli, and S. Abreu de Pessoa. 2009. "Pro- and Anti-Market Reforms in Democratic Brazil." In *Growing Pains in Latin America: An Economic Growth Framework as Applied to Brazil, Colombia, Costa Rica, Mexico, and Peru*, ed. L. Rojas-Suarez. Washington, D.C.: Center for Global Development.

Cazes, S., and A. Nešporová. 2007. *Flexicurity: A Relevant Approach for Central and Eastern Europe.* Geneva: International Labor Office.

Connor, W. 1997. "Social Policy under Communism." In *Sustaining the Transition: The Social Safety Net in Postcommunist Europe*, ed. E. Kapstein and M. Mandelbaum. New York: Council on Foreign Relations Press.

ECLAC (Economic Commission for Latin America and the Caribbean). 2006. *Shaping the Future of Social Protection: Access, Financing, and Solidarity.* Santiago: ECLAC.

———. 2007. *Social Panorama 2007.* Santiago: ECLAC.

Esping-Andersen, G. 1999. *Social Foundations of Postindustrial Economies.* Oxford: Oxford University Press.

———. 2002. *Why We Need a New Welfare State.* Oxford: Oxford University Press.

Ffrench-Davis, R., and J. L. Machinea, eds. 2007. *Economic Growth with Equity: Challenges for Latin America.* New York: Palgrave Macmillan.

Garret, G., and D. Nickerson. 2005. "Globalization, Democracy and Government Spending in Middle-Income Countries." In *Globalization and the Future of the Welfare State*, ed. M. Glatzer and D. Rueschemeyer. Pittsburgh: University of Pittsburgh Press.

Glatzer, M., and D. Rueschemeyer, eds. 2005. *Globalization and the Future of the Welfare State.* Pittsburgh: University of Pittsburgh Press.

Gilbert, N. 2004. *Transformation of the Welfare State: The Silent Surrender of Public Responsibility.* Oxford: Oxford University Press.

Gilbert, N., and R. Van Voorhis. 2003. *Changing Patterns of Social Protection.* New Brunswick, N.J.: Transaction.

Guha, Krishna, Delphine Strauss, and Chris Giles. 2009. "Big Countries Spar over $5bn Equity Plea." *Financial Times*, October 5.

Haggard, S., and R. Kaufman. 2008. *Development, Democracy, and Welfare States: Latin America, East Asia, and Eastern Europe.* Princeton, N.J.: Princeton University Press.

Handa, S., and B. Davis. 2006. *The Experience of Conditional Cash Transfers in Latin America and the Caribbean.* Working Paper 06-07. Rome: Agricultural and Development Economics Division, Food and Agriculture Organization of the United Nations.

Hemerijck, A. 2002. "The Self-Transformation of the European Social Model(s)." In *Why We Need a New Welfare State*, ed. G. Esping-Andersen. Oxford: Oxford University Press.

Huber, E. 2005. Globalization and Social Policy Developments in Latin America. In *Globalization and the Future of the Welfare State*, ed. M. Glatzer and D. Rueschemeyer. Pittsburgh: University of Pittsburgh Press.

IDB (Inter-American Development Bank). 2009. *Social and Labor Market Policies for Tumultuous Time: Confronting the Global Crisis in Latin America and the Caribbean.* Washington, D.C.: IDB.

IMF (International Monetary Fund). 2009a. *Regional Economic Outlook: Europe, October 2009.* Washington, D.C.: IMF.

———. 2009b. *Regional Economic Outlook: Western Hemisphere, October 2009.* Washington, D.C.: IMF.

———. 2009c. *World Economic Outlook: Sustaining the Recovery, October 2009.* Washington, D.C.: IMF.

———. Various years, a. *Government Finance Statistics Manual.* Washington, D.C.: IMF.

———. Various years, b. *International Financial Statistics.* Washington, D.C.: IMF.

Kapstein, E. 1997. "Conclusion: Toward a Political Economy of Social Policies." In *Sustaining the Transition: The Social Safety Net in Postcommunist Europe*, ed. E. Kapstein and M. Mandelbaum. New York: Council on Foreign Relations Press.

Kapstein, E., and M. Mandelbaum. 1997. *Sustaining the Transition: The Social Safety Net in Postcommunist Europe.* New York: Council on Foreign Relations Press.

Kogan, I., M. Gebel, and C. Noelke. 2008. *Europe Enlarged: A Handbook of Education, Labour and Welfare Regimes in Central and Eastern Europe.* Bristol: Policy Press.

Kramer, M. 1997. "Social Protection Policies and Safety Nets in East-Central Europe: Dilemmas of the Postcommunist Transformation." In *Sustaining the Transition: The Social Safety Net in Postcommunist Europe*, ed. E. Kapstein and M. Mandelbaum. New York: Council on Foreign Relations Press.

Larrañaga, O. 2009. "Inequality, Poverty and Social Policy: Recent Trends in Chile." OECD Social Employment and Migration Working Paper 85. Paris: Organisation for Economic Co-operation and Development.

Levy, S. 2006. *Progress against Poverty: Sustaining Mexico's Progresa-Oportunidades Program.* Washington, D.C.: Brookings Institution Press.

———. 2008. *Good Intentions, Bad Outcomes: Social Policy, Informality, and Economic Growth in Mexico.* Washington, D.C.: Brookings Institution Press.

Maddison, A. 2001. *The World Economy: A Millennial Perspective.* Paris: Organisation for Economic Co-operation and Development.

Midgley, J., and K. Leung Tang. 2009. *Social Policy and Poverty in East Asia: The Role of Social Security.* London: Routledge.

Orenstein, M., and M. Haas. 2005. "Globalization and the Future of Welfare States in Post-Communist East-Central European Countries." In *Globalization and the Future of the Welfare State,* ed. M. Glatzer and D. Rueschemeyer. Pittsburgh: University of Pittsburgh Press.

Pages, C., P. Gaelle, and S. Scarpetta. 2009. *Job Creation in Latin America and the Caribbean: Recent Trends and the Policy Challenges.* Washington, D.C.: World Bank.

Palacios, R., and M. Pallares-Miralles. 2000. "International Patterns of Pension Provision." World Bank Social Protection Discussion Paper 0009. Washington, D.C.: World Bank.

Peterson, Peter. 2009. "Questions America Must Ask on Health Costs." *Financial Times*, October 14.

Ramesh, M. 2007. *Social Policy in East and Southeast Asia*. London: Routledge.

Reinhart, C., and K. Rogoff. 2009. "The Aftermath of Financial Crises." NBER Working Paper 14656. Cambridge, Mass.: National Bureau of Economic Research.

Riboud, M., C. Sánchez-Páramo, and C. Silva-Jáuregui. 2002. *Does Eurosclerosis Matter? Institutional Reform and Labor Market Performance in Central and Eastern Europe*. Washington, D.C.: World Bank.

Rofman, R., L. Lucchetti, and G. Ourens. 2008. "Social Security in Latin America: Concepts and Measurements of Coverage." Social Protection Discussion Paper 0616. Washington, D.C.: World Bank.

Rose, R., and R. Shiratori, eds. 1986. *The Welfare State East and West*. Oxford: Oxford University Press.

Shiatori, R. 1986. "The Future of the Welfare State." In *The Welfare State East and West*, ed. R. Rose and R. Shiratori. Oxford: Oxford University Press.

Song, H. H., and H. Z. Hong. 2005. "Globalization and Social Policy in South Korea." In *Globalization and the Future of the Welfare State*, ed. M. Glatzer and D. Rueschemeyer. Pittsburgh: University of Pittsburgh Press.

Steiner, R., I. Clavijo, and N. Salazar. 2009. "Colombia's Efforts at Achieving Inclusive and Sustainable Growth." In *Growing Pains in Latin America: An Economic Growth Framework as Applied to Brazil, Colombia, Costa Rica, Mexico, and Peru*, ed. L. Rojas-Suarez. Washington, D.C.: Center for Global Development.

Szèkely, M. 2007. "Pro-Growth Social Policies for Latin America." In *Economic Growth with Equity: Challenges for Latin America*, ed. R. Ffrench Davis and J. L. Machinea. New York: Palgrave Macmillan.

Velasquez, M. 2003. *Seguro de desempleo, objetivos, características, y situación en América Latina*. Serie Financiamiento del desarrollo 133. Santiago: Economic Commission for Latin America and the Caribbean.

World Bank. 2007. *World Development Indicators 2007.* Washington, D.C.: World Bank.

———. 2008. *World Development Indicators 2008*. Washington, D.C.: World Bank.

———. 2009. *Conditional Cash Transfers, Reducing Present and Future Poverty.* Washington, D.C.: World Bank.

About the Author

Alejandro Foxley is a senior associate in the Carnegie International Economics Program and at the Corporación de Estudios para Latinoamérica (CIEPLAN) in Santiago, Chile.

Before joining Carnegie, Foxley was minister of foreign affairs of the Republic of Chile (2006–2009). From 1998 to 2006, he was a senator of Chile, serving as chairman of the Finance Committee and the Permanent Joint Budget Committee. Previously, he was also Chile's minister of finance and concurrently served as a governor of the Inter-American Development Bank and the World Bank (1990–1994).

From 1998 until 2002, Foxley was a member of the Carnegie Economic Reform Network (CERN), a distinguished group of former ministers and other senior policy makers who played key roles in advancing market-oriented economic reforms in developing and transitional economies.

From 1982 to 1989, he was Helen Kellogg Professor of Economics and International Development at the University of Notre Dame. Between 1973 and 1985, he was a visiting professor at the University of California, San Diego and Berkeley; MIT; Oxford; and the University of Sussex.

For his contributions to the field of economics, Foxley has been honored by the governments of France (L'Ordre national Légion d'honneur), Peru (Orden Sol del Perú en el grado de Gran Cruz), Austria (Gran Croix de Premier Class), Brazil ("Orden Nacional Cruzeiro do Sul" Gran Cruz), and Spain (Orden al Mérito Civil).

He is a former president and member of the board of directors of CIEPLAN, a think tank based in Santiago, and is the author or editor of fifteen books on economics, economic development, and democracy.

Carnegie Endowment for International Peace

The Carnegie Endowment for International Peace is a private, nonprofit organization dedicated to advancing cooperation between nations and promoting active international engagement by the United States. Founded in 1910, Carnegie is nonpartisan and dedicated to achieving practical results. Through research, publishing, convening and, on occasion, creating new institutions and international networks, Endowment associates shape fresh policy approaches. Their interests span geographic regions and the relations among governments, business, international organizations, and civil society, focusing on the economic, political, and technological forces driving global change.

Building on the successful establishment of the Carnegie Moscow Center, the Endowment has added operations in Beijing, Beirut, and Brussels to its existing offices in Washington and Moscow, pioneering the idea that a think tank whose mission is to contribute to global security, stability, and prosperity requires a permanent international presence and a multinational outlook at the core of its operations.

The new Carnegie **International Economics Program** (IEP) monitors and analyzes short- and long-term trends in the global economy, including macroeconomic developments, trade, commodities, and capital flows, and draws out policy implications. The initial focus of the Program will be the global financial crisis and the policy issues raised. Among other research, the Program will examine the ramifications of the rising weight of developing countries in the global economy.

CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE
1779 Massachusetts Ave., NW
Washington, D.C. 20036
United States
Phone: 202.483.7600
Fax: 202.483.1840
www.CarnegieEndowment.org
info@CarnegieEndowment.org

CARNEGIE MOSCOW CENTER
Tverskaya, 16/2
125009, Moscow
Russia
Phone: 495.935.8904
Fax: 495.935.8906
www.Carnegie.ru
info@Carnegie.ru

CARNEGIE-CHINA REFORM FORUM JOINT PROGRAM
Room 513, Chang Xin Building
39 Anding Road, Chaoyang District
Beijing, 100029
China
Phone: 86.10.6443.6667 ext. 627
Fax: 86.10.6894.6780

CARNEGIE MIDDLE EAST CENTER
Emir Bashir Street, Lazariah Tower,
Bloc A, Bldg. No. 2026 1210, 5th flr.
P.O. Box 11-1061
Downtown Beirut
Lebanon
Phone: 961.1.99.14.91
Fax: 961.1.99.15.91
www.Carnegie-mec.org
info@Carnegie-mec.org

CARNEGIE EUROPE
Avenue d'Auderghem, 82
1040 Brussels, Belgium
Phone: 32.2.735.56.50
Fax: 32.2.736.62.22
www.CarnegieEurope.eu
info@CarnegieEurope.eu

CARNEGIE ENDOWMENT
FOR INTERNATIONAL PEACE

WASHINGTON DC ▪ MOSCOW ▪ BEIJING ▪ BEIRUT ▪ BRUSSELS

17 PRINTED WITH SOY INK