

## CHAPTER 10

# Reducing Income Inequality

**M**uch of the increase in income inequality in Europe and Central Asia (ECA) reflects a welcome adjustment to an incentive and remuneration structure that rewards individual productivity. It is the natural and positive outcome of unleashing market forces and allowing individual returns to reflect individual effort. However, the polarization of incomes, severe in parts of the region, is not easily explained by productivity differentials or individual characteristics. In other countries of the world high inequality has impeded growth, undermined poverty alleviation, and fueled social tensions. Should policymakers in ECA then be concerned about the observed rise in inequality?

### Should ECA Policymakers Worry about Inequality?

There is mounting evidence that high inequality is bad for growth (Benabou 1997; Aghion, Caroli, and Garcia-Penalosa 1999). Recent empirical studies have documented an unambiguous negative correlation between the average rate of growth and measures of inequality across countries and periods. And recent theoretical work has shown that these empirical findings are consistent with modern microeconomic theories of incentives.<sup>1</sup> There are also links between economic inequality and other social goals. Medical researchers have found that high and increasing inequality, within countries, is highly correlated with worsening health outcomes and increasing mortality (Smeeding 1997). High inequality is also correlated with

greater social exclusion, declining confidence in the government, and impaired functioning of democracy.

For all these *instrumental* reasons, policymakers in Europe and Central Asia should worry about inequality. But they also should worry about inequality in its *own right*: because they believe in social justice and in maximizing social welfare. The new theoretical insights in economics show that, contrary to the traditional view, there need not be a tradeoff between social justice and productive efficiency (and/or growth). Redistribution can be good for growth.

Whether there are tradeoffs to reducing inequality or not depends greatly on the underlying forces that give rise to unequal outcomes. If disparities in outcomes arise purely from differences in effort and other decision variables of individuals, interventions to equalize outcomes may affect incentives and motivation, with negative consequences for overall social welfare. However, if unequal outcomes or achievements are related not exclusively to differences in effort but reflect also the impact of different human characteristics, which, in turn, affect individual capabilities (Sen 1992), the disincentive problem is fundamentally altered. If inequality of capabilities is related to gender or ethnicity (factors that cannot be easily changed), special treatment for the disadvantaged group may not generate the usual incentive problem. Thus, the ability of government action to influence inequality without major tradeoffs will depend critically on the specific policies, institutions, and social arrangements that underpin the distribution of income.

### What Can Governments Do to Reduce Inequality?

Some of the forces that have given rise to high inequality in parts of Europe and Central Asia may prove temporary, especially if the transition process deepens and appropriate institutions to support the market and a pluralistic society develop. An important part of the jump in inequality (especially in the Commonwealth of Independent States) reflects the widespread quasi-rents resulting from incomplete or noncompetitive markets, from distortionary policies, or from corrupt government practices. If markets start to function better and governance improves, we would expect inequality in much of the CIS to come down.

However, the move toward less inequality is not automatic. Current inequities can become entrenched and affect the development of institutions and policies in ways that are not easily reversible. More accountable and less corrupt governments, better-functioning markets, and appropri-

ate institutions can emerge only if society at large demands it. Yet inequality of the magnitude seen in some of the CIS republics is already eroding the ability of those at the bottom (and possibly those in the middle) to influence political outcomes and government action. This can only lead to a greater polarization of society, increased economic insecurity, impaired democracy, and rising violence and social dislocation.

Governments can do much to mitigate the unequal outcomes that the transition may generate (table 10.1). They can also make things worse.

**Table 10.1 Policy Measures to Reduce Inequality, by Subregion**

<i>Policy</i>	<i>Central and Eastern Europe and the Baltics</i>	<i>Southern Europe and the Balkans</i>	<i>Commonwealth of Independent States</i>	<i>Caucasus and Central Asia</i>
Building transparent and efficient product markets <sup>a</sup>	Fairly advanced but taxes and regulation burdensome for new firms.	More progress needed. Licensing, regulations, and anticompetitive practices hamper expansion of private firms.	High priority. Anticompetitive practices, licensing, regulations, and corruption hamper entry and expansion of new private firms.	High priority. Anticompetitive practices, licensing, regulations, and corruption hamper entry and expansion of new private firms.
Expanding financial markets <sup>a</sup>	Shallow by OECD and East Asia standards, but comparable to Latin America and the Caribbean. New firms and especially small enterprises still face difficulties accessing long-term finance.	Very shallow credit markets; private/small firms and SOEs have differential access.	Very shallow credit markets; unequal access for private/small firms and SOEs; connections are important.	Very shallow credit markets; unequal access; small firms face problems financing even working capital.
Raising the incomes of those at the bottom through labor market reforms <sup>b</sup>	Focus on raising incomes of low-skilled workers while maintaining wage flexibility. Antidiscrimination policies.	Focus on raising incomes of low-skilled workers while maintaining wage flexibility. Antidiscrimination policies.	Wage inequality high. Product markets and governance are key. Skill upgrading for poorest important in medium term.	Wage inequality high. Product markets and governance are key. Skill upgrading for poorest important in medium term.
Using distributive fiscal policy	Large scope for using fiscal policy. Focus on improving targeting of transfers. Policies to foster accumulation of public capital and education in poorest regions (within countries).	Scope to improve taxation and tax compliance, as well as targeting of transfers. Restoring fiscal balance is key. Possible scope for regional policies.	Scope to improve tax compliance and budget execution (arrears). Improve targeting of transfers. Possible scope for regional policies.	Priority is improving tax compliance, expenditure prioritization, and budget execution. Limited role for transfers in short to medium term (too poor).

a. A policy that is needed to sustain growth; it also will have positive distributional effects.

b. The focus of this policy is to change the distribution of income.

Source: Chapter 10.

As chapter 4 explained, governments' bad policies—excessive regulation and licensing, subsidized directed credit, protection of vested interests at the expense of the broader population—contributed significantly to the large income disparities in the CIS. History is rife with other examples: many Latin American governments tried for decades to mitigate entrenched inequality with populist policies (massive subsidy schemes, unmanageable progressive taxation, restrictive labor legislation), and they achieved mostly the opposite effect (IADB 1998).

To be effective, government policy must reflect an understanding of the nature and causes of inequality. Policies to reduce inequality in Europe and Central Asia must also recognize the diversity of causes and the large variance in institutional capacity across the region. In the countries of Central and South Eastern Europe and the Baltics (CSB), strong governments are in place, markets are functioning quite well, and the development of market-supporting institutions is well advanced; therefore, much can be accomplished through properly designed redistributive fiscal policy. There is also scope to improve the distribution of income through measures aimed at building the skills (and hence the income-earning opportunities) of less-educated workers and of marginalized groups. Moreover, the process of accession to the European Union can provide an invaluable mechanism for reducing regional disparities (structural funds) and for continuing economic and social reform.

Reducing inequality in the Commonwealth of Independent States will be much more complicated. Inequality in the CIS appears linked to failed government policy and especially to the failure to carry out reforms that go against the powerful vested interests that have grown out of the early stages of transition. Thus, there is much less political support for redistribution and for the measures that may be required than in the more advanced reformer countries. The problem of state capture in some of these countries is severe, and a captured state is unlikely to be responsive to distributional concerns. Policies to address poverty and reduce inequality in these countries must be linked to political reform and to efforts to build institutions that will deliver accountable and responsive governments with adequate checks and balances. The discussion in this chapter focuses on what can be accomplished through *economic* policy to reduce inequality and improve distributional outcomes. The need for accompanying *political* reform and an appropriate institutional context was discussed in chapter 5.

Given these constraints, what can governments do to reduce inequality in the CIS? The choice of policy measures relates to the factors that caused the collapse of formal employment and incomes. A first priority would be to eliminate excessive regulation, licensing, and other product market dis-

tortions; correct misdirected credit and financial sector policies; and build a functioning labor market (that is, governments need to continue on a determined path of economic reform, paying particular attention to building more open and efficient product and factor markets). These policies are necessary to restore and sustain growth, but they will also have positive distributional implications.

Second, CIS governments can focus more directly on affecting the distribution of income. They can try and raise the incomes of those at the very bottom through measures, such as antidiscrimination policies and legislation, that will enhance their earnings potential and remove barriers to their employment. In addition, these governments should rebuild their capacity to deliver basic services and carry out an effective fiscal policy (by collecting taxes in a fair and effective way, setting expenditure priorities in a transparent and accountable manner, and monitoring the delivery and quality of public services). Superimposed on these two priorities, and of special importance in Europe and Central Asia, is the need to prevent governments from being coopted by special interests and to ensure that governments are representative and accountable to their populations (chapter 5).

### Building Transparent and Efficient Product Markets

Without well-functioning product markets, new formal sector employment opportunities, the key to reducing income disparities, will not emerge (EBRD 1999).<sup>2</sup> Competitive product markets are also essential to stimulating the restructuring of nonviable enterprises. Such restructuring would reduce the prevalence of wage arrears (or forced borrowing from workers), which is contributing to high wage inequality in the CIS.<sup>3</sup> Increased competition, liberalization, and deregulation would reduce monopoly rents. This, in turn, would diminish the gains to firms from lobbying and corrupting the state. State capture would be reduced and overall governance improved. All of these developments can promote growth, and they can improve distributional outcomes.

How much of an impact could continued market liberalization have on reducing inequality among the high-inequality ECA countries? To answer this question we compare high- and low-inequality countries and then simulate a simple counterfactual. Table 10.2 shows the regression of the Gini coefficient on measures of overall reform and on initial conditions for (1) a cross-section of ECA countries at one point in time and (2) for a pooled sample of countries over several years. For the cross-section regressions,

**Table 10.2 Regressions of Income Ginis on Liberalization Index and Initial Conditions**

<i>Index</i>	<i>Cross-section of ECA countries 1996–97</i>		<i>Pooled sample, multiple years<sup>c</sup></i>	
	<i>All available Gini statistics (24 countries)</i>	<i>Only income Ginis (24 countries)</i>	<i>All available Gini statistics (24 countries)</i>	<i>Only income Ginis (24 countries)</i>
De Melo, Denizer, and Gelb reform index <sup>a</sup>	1.480	1.528 (2.860)	— (2.821)	—
Liberalization index <sup>b</sup>	—	—	27.027 (2.635)	28.294 (2.390)
Initial Gini (1989–90)	113.41 (1.981)	136.85 (2.052)	152.84 (3.350)	155.11 (3.275)
Initial income per capita	-0.0008 (-0.607)	-0.0002 (-0.138)	-0.001 (-0.960)	-0.001 (-1.028)
Dummy for consumption Gini	-10.48 (-2.040)	—	-10.668 (-2.474)	—
R <sup>2</sup>	0.699	0.703	0.413	0.419

*Note:* dummy =1 if Gini is consumption Gini.

a. A higher value means less reform (not available for pooled data).

b. From Dethier, Ghanem, and Zoli (1999). A higher value means less reform (used in pooled regressions).

c. Standard errors corrected for nonindependence across observations on same country.

*Source:* Dethier, Ghanem, and Zoli (1999) data combined with Ginis from latest household surveys.

we use the De Melo, Denizer, and Gelb (1996) reform index, which is a comprehensive index of progress on diverse reform fronts. A higher value indicates less reform: thus, a positive coefficient indicates that countries that have made less progress on reforms are also the ones with higher inequality outcomes. For the pooled regressions we do not have the De Melo, Denizer, and Gelb index; therefore, we use an alternative liberalization index provided by Dethier, Ghanem, and Zoli (1999). Unlike in the cross-section regressions, in the pooled regressions the estimated coefficients are influenced by variation in the data across countries as well as by changes over time within countries. However, the relationship between reforms and inequality appears to be the same.

Table 10.3 presents predicted inequality from the cross-section regressions shown in table 10.2 under two scenarios. The first scenario maintains the explanatory variables at their actual levels; the second assumes that the CIS countries achieved the same level of progress toward com-

**Table 10.3 Predicted Gini Coefficients for the Commonwealth of Independent States under Alternative Scenarios**

<i>Explanatory variables</i>	<i>At actual levels</i>	<i>CIS progress resembles CSB progress</i>
Reform progress	0.46	0.38
Initial conditions	—	0.40

*Note:* The predicted inequality for Central and Eastern Europe is 0.31. This is for a cross-section sample. Members of the CIS are Armenia, Azerbaijan, Belarus, Georgia, the Kyrgyz Republic, Moldova, Russian Federation, Ukraine, Tajikistan. The countries in Central and South Eastern Europe and the Baltics are Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, FYR Macedonia, Poland, Slovak Republic, and Slovenia.

*Source:* Simulations based on table 10.2.

petitive markets as the group of CSB countries (but keeping the initial conditions distinct). We also predict what the level of inequality would be for the CIS sample if the initial conditions had been the same as in the CSB, but progress on liberalization had followed its actual path. The results suggest that if the CIS countries were to achieve the same level of market development as the average CSB country, the predicted income Gini would drop by 8 Gini points. Changing the initial conditions for the CIS without altering its liberalization path would reduce the predicted income Gini but not by as much.

Continued progress in building competitive markets appears to be good for distribution and good for growth. But what aspects of market development should countries focus on? Is domestic price liberalization more or less important to inequality than the liberalization of external transactions? And how do these factors compare with other aspects of macroeconomic stability? While we are limited by the availability of comparable data across countries, some suggestive evidence can be inferred from regressions of the income Gini on alternative measures of reform progress. Because the cross-section sample is too limited to carry these out, we present the results only for the pooled sample (table 10.4).

This exercise is hampered by the difficulties of measuring progress on any of these fronts accurately. Because the measures are highly correlated among themselves, attempts to isolate their individual effects may be futile. However, some interesting findings do emerge. If we limit our analysis to the liberalization variables, we find that price liberalization is more correlated with inequality than with the liberalization of external transactions or other measures of private sector development (columns 1 and 2). However, this result largely disappears when measures of macroeconomic stability and the governments' fiscal stance are added to the regression.

**Table 10.4 Liberalization and Inequality, Alternative Specifications**

	(1)	(2)	(3)	(4)	(5)	(6)
Trade and foreign exchange	-7.129 (-0.372)	-12.271 (-0.623)	-0.191 (-0.011)	-5.348 (-0.337)	-8.944 (-0.406)	-4.579 (-0.165)
Price liberalization	-39.262 (-1.761)	-38.088 (-1.686)	-24.303 (-1.142)	-10.203 (-0.489)	-3.416 (-0.108)	-44.066 (-1.502)
Private sector development	—	5.396 (0.634)	—	—	—	—
Government expenditures (% of GDP)	—	—	-5.447 (-2.493)	-6.309 (-2.939)	—	—
Government deficit (% of GDP)	—	—	—	8.563 (2.241)	—	—
Volatility 1 (standard deviation of inflation)	—	—	—	—	0.0144 (3.041)	—
Volatility 2 (standard deviation of GDP growth)	—	—	—	—	—	0.650 (1.958)
Initial Gini	135.27 (2.883)	135.53 (2.866)	143.59 (2.832)	105.53 (2.303)	72.485 (1.364)	91.069 (2.247)
Initial income per capita	-0.0001 (-1.403)	-0.0001 (-1.363)	-0.0001 (-0.786)	0.0001 (0.288)	-0.001 (-1.011)	-0.001 (-0.890)
R <sup>2</sup>	0.485	0.488	0.498	0.601	0.581	0.534

*Note:* Regressions on pooled data for 20 ECA countries (multiple observations by country). Standard errors were corrected for heteroskedasticity and autocorrelation.

*Source:* Same as table 10.2.

The inclusion of the macroeconomic variables swamps the liberalization effect and renders it insignificant, suggesting that stabilization is a prerequisite for the development of markets and further reform. Both of our measures of macroeconomic instability—the standard deviation of inflation over the period and the standard deviation of real GDP growth—are positively, and significantly, related to inequality. The effect of inflation is particularly strong, highlighting its important distributional costs. The fiscal variables are also significantly correlated to inequality. The size of government spending (expenditures as a percentage of GDP) has an inequality-reducing effect, but this effect is not independent of the size of the government deficit. Government deficits, in fact, have a regressive impact

on the distribution of income, and this impact is of a magnitude largely similar to the positive effect of government spending.

### Expanding Financial Markets and Building Sound Credit Policies

This book has highlighted the role of low wages, particularly for the less educated, as an important determinant of income inequality and poverty. But wages are markedly influenced by the amount of capital with which workers can operate. When formal labor markets become relatively unimportant and households resort to self-employment and small-scale entrepreneurial activity for their main source of income, the availability of credit to finance capital investments becomes critical. Indeed, it can become the key determinant of the returns to labor and hence of a family's well-being. This is especially true for rural families who may depend solely on the income generated from their farming activities. World Bank (1999c) found that in Georgia rural families with access to credit and/or to capital inputs complementary to land were much less likely to be poor than those without such complementary inputs.

Well-functioning credit markets are needed to sustain formal employment. In Latin America, for example, shallow financial markets have been directly associated with high informalization of employment (IADB 1998). As the Latin America experience illustrates, formalization is usually a hallmark of the development of a market economy, but this process can be short-circuited if the domestic financial system is not up to the task. When financial markets are shallow, entrepreneurs and the self-employed often remain involved in small-scale, informal activities because they cannot obtain the credit to finance the expansion and formalization of their enterprise.

Credit markets are likely to be especially distorted in Europe and Central Asia because of the legacy of central planning, under which credit was allocated on a noneconomic basis to different activities and frequently used as a political tool. Moreover, many ECA countries started the transition with bouts of hyperinflation, which wiped out financial savings and destroyed much of the incipient financial system. The resulting scarcity of capital has negatively affected not only economic growth but also the distribution of income: poor households were more affected by the disappearance of prior savings and less able to gain access to credit, even informal credit, following hyperinflation (World Bank 1999a, 1999c; Gomart 1999).

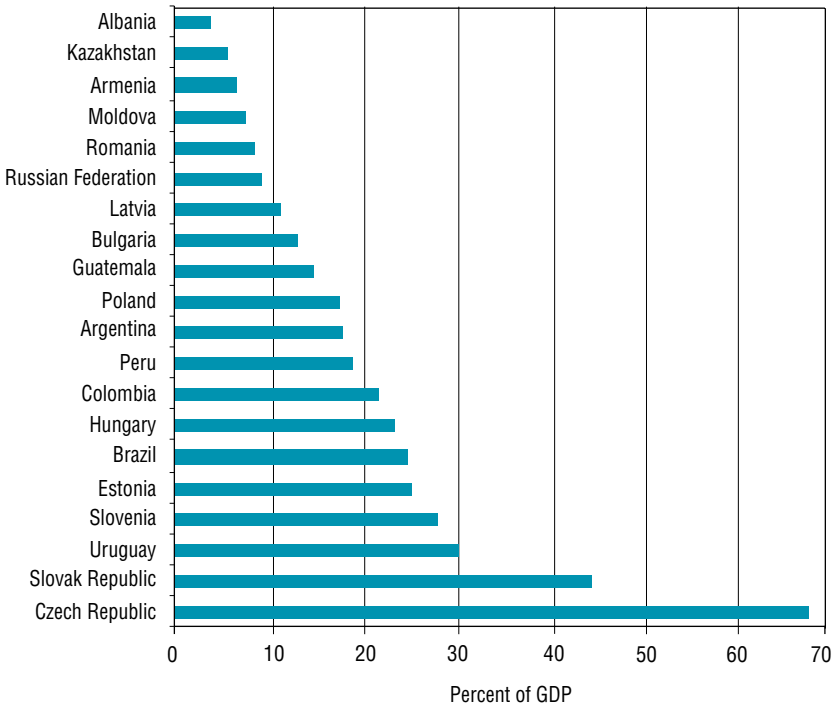
In many ECA countries the shortage of credit has not been alleviated with the return to stable (and low) inflation rates: large fiscal deficits financed through high-yield government emissions have, in some countries, siphoned away scarce domestic (and foreign) savings from productive investments, which do not yield the same return in the short-term. World Bank (1999f) showed that more than three-quarters of the portfolios of the largest banks in Armenia were invested in government bonds, leaving only a minuscule fraction of resources available for loans to productive private sector endeavors. Even in an advanced reformer country like Slovenia, the public sector is crowding out a substantial share of the resources that could be available to the private sector (World Bank 1999e). The resulting scarcity of credit is particularly severe for small businesses and potential entrepreneurs, whose financial needs are typically greater and whose creditworthiness is more difficult to assess. This shortage of credit restricts the ability of small businesses to obtain access to the working capital and physical capital necessary to raise their productivity and expand their enterprises.

### Shallow Financial Markets Contribute to High Inequality

In Europe and Central Asia financial depth—measured either as the ratio of broad money supply to GDP or as financial system credit to the private sector as a percentage of GDP—is much lower than in East Asia or even in Latin America (figure 10.1). The exceptions are the more advanced EU accession countries, where financial markets appear fairly comparable to those in Latin America in terms of depth although they are still much shallower than those in the OECD. At the other extreme we find the economies of the Caucasus and Central Asia. These countries have financial markets that are underdeveloped even by the standards of low-income countries. With ratios of broad money to GDP in the range of 7 to 12 percent, and banking sector credit to the private sector in the range of 2 to 6 percent, the financial markets of those countries are shallower than those in much of South Asia and parts of Africa. Other measures of financial market development, such as stock market capitalization, yield a similar picture.

Squire and Zou (1998) found that shallow financial markets are strongly associated with higher income inequality. In fact, they find that financial depth has one of the largest quantitative impacts on the Gini coefficient among all the variables considered. A similar, albeit weaker, correlation between financial depth and inequality was found with regard to Latin

**Figure 10.1 Banking Sector Credit to Private Sector in Selected ECA and Latin American Countries**



*Source:* World Bank SIMA database.

America (IADB 1998). Shallow and inefficient financial markets in Europe and Central Asia, and especially in the CIS, may be one of the reasons for the emergence of such high disparities in income.

Financial markets affect income inequality in a number of ways. Deep financial markets facilitate savings and the accumulation of capital, raising labor productivity and wages and driving down the returns to capital. This tends to improve the distribution of income because most households depend on wage incomes, while capital income accrues mainly to a more concentrated group of individuals. Higher capital accumulation promotes growth, which tends to feed back to wages. In contrast, if financial markets are not functioning effectively, domestic investment will be lowered, and the ensuing scarcity of capital will affect both growth and the distribution of income. If financial markets are weak, credit be-

comes particularly inaccessible to low-income individuals and small businesses. This has implications for the earnings of those who rely on small-scale activities to make their living. Therefore, there is a direct impact on inequality. But shortage of credit to small businesses can also have a negative impact on overall employment creation and thus on average wages and incomes.

There is evidence that the banking system provides limited credit to small enterprises even in the more successful reformer countries. EBRD (1999) finds that inadequate access to financing ranks second among the main barriers to entry and expansion of new private firms in Central and South Eastern Europe (after taxes and regulations). Access to long-term financing is a particular problem, even in advanced reformer countries such as Hungary or Poland. Small entrepreneurs' access to credit is even more restricted in the CIS, where access to working capital can be difficult. Throughout the region access to finance is significantly more difficult for start-ups and new firms than for state-owned enterprises (SOEs), and it is shown to depend greatly on special connections to banks and on other noncompetitive practices (EBRD 1999).

### Financial Policies to Reduce Inequality

Chapter 6 discussed the major obstacles to the development of well-functioning financial systems in many ECA countries and proposed policy instruments to foster this development. However, even relatively well-functioning financial systems can fail to serve small and low-income borrowers. This is because small borrowers face particular obstacles in securing credit. From the point of view of the lender, monitoring small loans is much more expensive (as a fraction of loan size) than monitoring larger loans; moreover, the cost of enforcing repayment, if forced to go through the legal system, is proportionately much higher. Hence, if credit is to be made available to the poor, even greater care needs to be taken to ensure an appropriate regulatory and legal framework.

Beyond the standard measures to liberalize and create competitive financial markets and to establish appropriate supervisory institutions, what other reforms are needed to ensure that credit in ECA countries is available to the poor? Reforms to promote broader availability of credit may include, first of all, appropriate regulation and supervision of banking institutions that lend to small and microenterprises. Standard prudential banking regulations and supervisory practices (designed with traditional commercial-bank-lending technology and large loan sizes in mind) may

unintentionally impede lending to small and microenterprises. Lending technology for micro loans can differ in important ways from that which is appropriate for larger customers. Applying supervisory norms appropriate for larger loans may make micro loans too expensive and reduce supply. To allow for micro lending, the regulatory and supervisory framework may have to be adapted with regard to operational restrictions, documentation requirements, capital requirements, and the treatment of collateral.

To promote expanded access to credit by small enterprises, ECA governments must establish an adequate legal and institutional framework for secured transactions. In much of the region, inadequate or nonexistent legal registries impede the use of movable goods or real property as collateral to secure loans. While this problem affects all firms, its greatest impact is on small firms. Sometimes the problem is the law itself. In Armenia, for example, the law restricts the kinds of goods that can be used as collateral (allowing only nonmovable property). This effectively limits access to credit for many small entrepreneurs. Even when the law allows for the use of different types of collateral, access to credit can be impeded by the lack of supporting institutions and implementation mechanisms. For example, a pervasive problem in the region is the lack of appropriate collateral registration procedures and of legal registries that allow a lender to ensure that there are no prior superior claims on an asset that a borrower pledges as collateral. The lack of legal registries is bound to be a more serious problem for small borrowers with no established reputation than for larger borrowers with well-established assets, reputations, and connections.

The most egregious failure in this regard is the lack of adequate land registries in many of the CIS countries, which impedes the use of the most important potential source of collateral for many households. Some countries have attempted to lessen this problem through extensive land titling programs to regularize the property rights of small farmers and tenants. Even in the absence of well-functioning legal registries, such titling can provide beneficiaries with an acceptable form of collateral and thus greater access to credit. However, progress with land titling in parts of the region has been fairly slow. In some cases progress has been hindered by land titling fees and property taxes, which some cash-strapped farmers have not been able to pay (Gomart 1999).

Other measures to improve the availability of credit to small borrowers could include establishing or strengthening credit bureaus, improving the legal framework for leasing and factoring, facilitating the development of

small capitalization rural banks, and fostering the development of credit unions. Experiences to date with the promotion of rural credit unions in Armenia, Georgia, and Moldova have been very successful (chapter 5).

### Labor Market Policies to Improve Distribution

Much of the inequality in Europe and Central Asia is associated with the collapse of formal wages and incomes for unskilled workers. Unskilled workers in Central and Eastern Europe and in the Baltics have seen their wages fall relative to those of more educated workers; and in some cases (Bulgaria and Estonia, for example), they have seen their real wages collapse in absolute terms as well. The formal incomes of unskilled workers in the CIS have plummeted in an even more striking manner. As a result, many of these workers have had to resort to secondary employment in either agriculture or trade as the sole means to maintain household incomes. Throughout the region, wage structures have shifted, devaluing the work of production workers relative to nonproduction activities (thus reversing the relative overvaluation of physical labor imposed by central planning).

At the core of these developments is reduced demand for low-skilled workers in response to (1) the restructuring of the formerly planned economies and (2) the removal of institutional constraints on wage setting. The pattern of this demand shift has differed markedly within the region. In the CSB countries there have been shifts in relative labor demands: low-skilled and poorly educated workers have lost out. In the CIS the real problem is the collapse of labor demand altogether; demand for both low-skilled and high-skilled workers has crashed.

In this context what can government policies do to reduce wage inequality? Given the differences in the underlying forces at work, will policies differ between CSB and CIS countries? The issue of regenerating formal labor demand in the CIS is intrinsically linked to establishing well-functioning factor and product markets that will allow private enterprise and demand for labor to spring up. Measures to support this were discussed in chapter 6. Here we will focus instead on policies to raise the wages of the unskilled.<sup>4</sup>

Policies to raise the wages of unskilled or low-skilled labor fall into two categories: policies to establish a minimum wage or wage floor; and policies to facilitate investments in human capital and to increase the productivity of the less skilled. Also important in the ECA context are policies to protect the income of workers who become temporarily unemployed, since

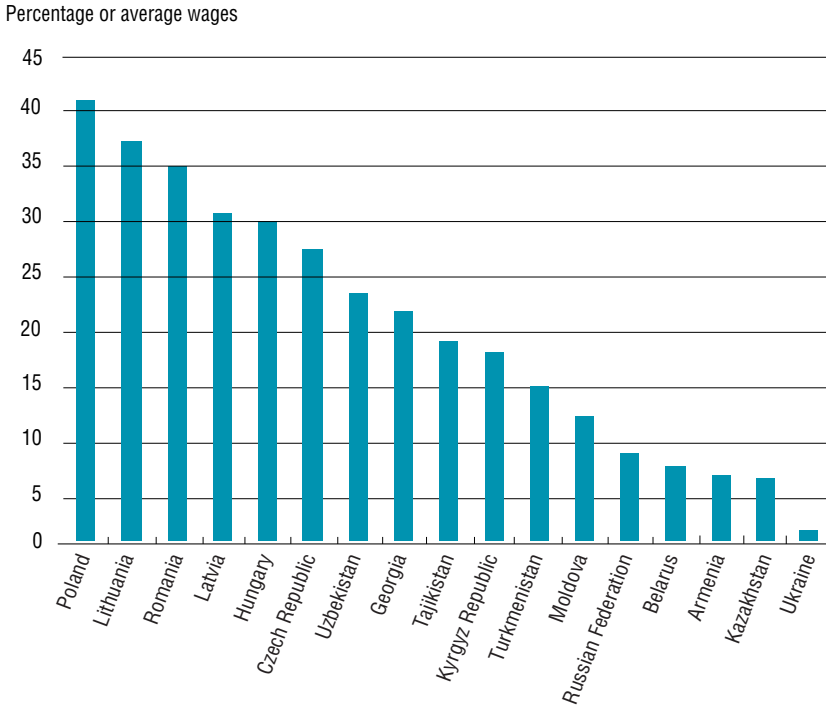
these workers are likely to be low-educated or unskilled. These policies, discussed at length in chapter 8, will not be addressed here, except to note their impact on the distribution of wage incomes. Finally, policies to foster the labor force participation of women (and remove constraints such as discrimination or lack of childcare) can also have an important distributional impact.

### Minimum Wages

The minimum wage has been used worldwide as a redistributive mechanism and an income protection mechanism for the poorest workers. Under central planning, the minimum wage directly and indirectly played this role in Europe and Central Asia as well. The intention was to provide a minimum acceptable threshold of wages (reflecting minimum living standards) for less-skilled workers. With the transition, however, the old standards for the minimum wage in many countries (especially in the former Soviet Union) have become meaningless or are not enforced. Given the observed large increase in inequality in much of the region, is there a renewed role for minimum wages?

The minimum wage plays a very different role in the CSB countries than it does in the CIS (figure 10.2). Minimum wages in the Eastern European countries are set at around 30 to 40 percent of the average wage—a level that is not high by OECD standards but high enough to provide a floor for low-skilled wages. In the case of Poland, the earnings distribution shows a big spike at the level of the minimum wage, which appears to be binding for blue-collar workers in some low-paying sectors (Rashid and Rutkowski 2000). In contrast, minimum wages in most of the CIS have fallen well-below subsistence levels, and they represent a negligible share of the average wage. In these countries minimum wages—when observed—are irrelevant as a policy for protecting workers.

There is an intense debate in both industrial and developing countries over the effectiveness of minimum wages as a redistributive tool. The overall evidence suggests that minimum wages may lead to small declines in inequality and somewhat larger positive effects on poverty. One study for the United States found that the decline of the real value of the minimum wage explained about one-third of the increase in wage inequality during the 1980s (Dinardo, Fortin, and Lemieux 1995). A different study, however, found only modest effects on earnings inequality and virtually no effect on family income inequality (Horrigan and Mincy 1993). In developing countries, most of the evidence points to very small effects. Bell (1997), for example, found that in Columbia the impact of the minimum

**Figure 10.2** Minimum Wages in Europe and Central Asia, Selected Countries, 1997

Source: Rashid and Rutkowski (2000).

wage on inequality was small, and it persisted during the period of economic recession. Ramos and Reis (1995) found a similarly small impact of minimum wages on inequality in Brazil. And the IADB (1998) found that reductions in minimum-wage purchasing power were associated with increases in the concentration of incomes (and vice versa) in 11 Latin American countries.

However, the use of minimum wages also has well-known risks. Some studies, mainly on OECD countries, have documented a negative effect of minimum wages (when set too high) on growth and employment, with long-term adverse effects for the poor. When labor markets are dualistic, as in many developing countries, minimum wages can work to lower the wages of workers in the informal sector, who are typically more needy (World Bank 1995). Once a minimum wage is set, pressures for it to be raised in real terms can be considerable. The risks of setting a too high minimum wage in Europe and Central Asia are of particular concern for the EU accession countries, where pressures to raise minimum wages to

European levels ahead of labor productivity could increase unemployment. Consider the experiences of Spain and Portugal following their accession to the European Union. Although both countries suffered similar economic shocks and had similar labor market institutions, Portugal has weathered the postaccession process with significantly less unemployment than has Spain. One possible reason for this is that Portugal has a much lower statutory minimum wage and less binding wage floors arising from collective bargaining. As a result, it has had more real wage flexibility at the bottom of the distribution than has Spain (box 10.1).

For the minimum wage to raise the real incomes of the poorest workers, it must meet three conditions. First, it must not reduce aggregate employment demand. Typically, this will require that the minimum wage be set low (below 40 percent of the average wage). When the minimum wage is low, it does not noticeably affect aggregate employment levels. When it is high, the employment destruction effects can be severe; the experience

#### **Box 10.1 EU Accession and Income Inequality: The Cases of Spain and Portugal**

Economic integration can exert a powerful influence over the distribution of income. In much of Latin America, economic integration has been associated with increasing inequality. Both Mexico and Chile, for example, experienced sharp increases in wage dispersion and growing inequality of incomes. However, the experience of those countries that recently acceded to the European Union was quite different. In both Spain and Portugal, income disparities declined during the 1980s following their accession into the EU. During the 1990s, household income inequality increased in Portugal but remained fairly flat in Spain. In both countries, market forces may have worked toward increasing disparities, but in Spain this was countered by the impact of taxes and transfers. In Portugal, on the contrary, national redistributive policies have been less relevant in terms of shaping the distribution of income.

EU regional policies and transfers have reduced regional differences in labor productivity in both countries. But given the low fraction of total income inequality explained by differences between regions, and the divergence of regional employment rates (especially in Spain), the overall impact of EU regional policy instruments has been relatively small.

Wage inequality has increased in both Spain and Portugal, reflecting a shift in the demand for labor toward higher skilled workers. The reduction of employment and wage shares of manual, semi-skilled, and low-skilled workers has been strong in manufacturing as well as in nontradable sectors such as transport. However, in Portugal, trade patterns favoring labor-intensive products, such as textiles, have sustained the wages of low-skilled workers and led to relatively low unemployment. In Spain, the sharp decline in demand for low-skilled workers combined with a rigid labor market; the result was very high levels of unemployment. Institutional arrangements, such as collective bargaining and the minimum wage, protected the wages of low-skilled workers in Spain more than in Portugal. Wages at the bottom of the distribution actually increased in Spain. This was another factor adding to high unemployment.

*Source:* Jimeno and others (2000).

of Puerto Rico during the 1970s, when it (briefly) adopted the U.S. minimum wage, is an example. Puerto Rico's experience, along with that of other countries, suggest that with high minimum wages, the elasticity of employment with respect to changes in the minimum wage can be over 1 (Castillo-Freeman and Freeman 1990).

Minimum wages in Europe and Central Asia are not especially high (figure 10.2), and they are unlikely to have significant aggregate employment effects. In the Czech Republic, for example, less than 10 percent of all employees earn the minimum wage (World Bank 1999b). However, in some CSB countries with higher minimum wages, most notably Poland, the minimum wage may be binding for certain groups (low-skilled, manual workers in low-paying sectors), and it may be hurting youth employment (Rashid and Rutkowski 2000). This suggests the need for caution in raising the real level of the minimum wage, particularly as these countries face EU accession.

Second, for the minimum wage to be effective as a redistributive mechanism, compliance must be high. This again will require that the minimum wage be set low: if the minimum is set so high that it affects employment, displaced workers and employers will collude to evade it. Evasion is likely to be as much of a problem in large enterprises as in small ones. In Venezuela and El Salvador, six out of every ten workers paid significantly less than the minimum wage are employed by large enterprises (IADB 1998). Unfortunately, reliable evidence on compliance with minimum wages in Europe and Central Asia is scarce. In Central Europe compliance is estimated to be quite high. However, in the CIS, getting enterprises to comply with payroll and other tax regulations is difficult. This signals that compliance would likely be a serious problem there as well.

Third, the minimum wage, to be effective, must be set at a level that covers a substantial group of low-income workers. Even when the minimum wage is set low, it can be badly targeted. In Argentina, where the minimum wage is set very low, only 30 percent of workers earning that level of wages come from the poorest quintile of the population. Just above 20 percent belong to the second quintile, and the rest come from middle-class and upper-class families. More than half of those who earn the minimum wage are young people who may or may not come from low earner households (IADB 1998). No comparable information is available for ECA countries, but evidence from Poland suggests that the minimum wage there may disproportionately affect young workers, independent of their household income. In this case, and even in the best of circumstances (no employment effect and high compliance), increases in the minimum wage will affect the overall distribution of income only slightly. In other words,

as a tool to influence the distribution of income, the minimum wage will be largely ineffective.

One possibility for improving the targeting of the minimum wage is to distinguish between the wage paid to young workers and that paid to potential heads of household. Governments can establish a lower minimum wage for young workers, as is done in many European countries. An additional advantage of this approach is that it can reduce employers' disincentive to hire young workers with little or no experience, which is likely to exist when the adult minimum wage is binding for them as well.

An alternative to the minimum wage is to use wage supplements for low-income workers. In the United States the earned income tax credit is an example of this type of tool. It works as a negative tax for low-income workers and is administered by the tax collection office. These programs, however, can introduce perverse incentive effects. Indeed, there is the danger of creating a "poverty trap." Moreover, wage supplement programs are administratively very burdensome—and hence unsuited to many ECA countries with weak institutional capacity. Another alternative is to subsidize enterprises that contract workers below a certain income level. The hope would be that the subsidy would reduce unemployment of low-skilled workers and thus affect the distribution of earnings. However, as the experience in industrial countries has shown, enterprises often simply "churn" low-wage workers, with few real gains in terms of overall employment and incomes. Programs in the Czech Republic, Poland, and Hungary have yielded mixed results. Positive and lasting employment effects have been identified in Poland, but the benefits in the other two countries are less clear (Fretwell, Benus, and O'Leary 1999).

### Training and Investments in Worker Productivity

Formal education affects income inequality through its long-term effects on the earnings potential of children from low-income families and through its effect on labor supply decisions of women. But formal education holds little hope for raising the income or employment possibilities of low-educated adults who have long since left school. For these individuals, training programs and other forms of assistance to increase their skills could, however, make a difference. Such training would aim at providing them with new skills better suited to the market economy.

The effectiveness of training schemes has been debated for a long time. There is a wealth of evaluation studies, with different methodologies and settings and with widely different results. This makes it hard to arrive at any firm conclusions. However, the general evidence suggests that some

types of training programs, especially those directly linked to potential employers, can be effective. Program size and design are critical to their performance. Standardized training programs do not fit all workers; the programs must be targeted and tailored carefully. A recent study evaluated training schemes for unemployed workers in three transition countries (the Czech Republic, Hungary, and Poland) and found generally positive, although very small, employment effects. The employment effect was larger for women than for men (a finding common to most evaluations of OECD training schemes), and for young and middle-age workers than for older workers. Training was also found to be more effective for workers with low levels of education (primary and secondary as opposed to postsecondary education)—a finding consistent with the large skill-mismatches within these economies resulting from the low level and low quality of the educational stock (Fretwell, Benus, and O’Leary 1999).

The Fretwell, Benus, and O’Leary study, unfortunately, was limited to evaluating programs in those three higher-income Central European transition countries. We know little about the actual or potential effectiveness of programs in other countries of the region. The potential for training or other types of active labor market policies in countries with large informal markets, a collapsed formal labor demand, limited administrative capacity, and a limited information base may, in fact, be very small.

Training programs can help individuals with or without experience upgrade their skills, but the training must be offered on a selective basis and only after a careful examination of labor market conditions. All programs should have an impact evaluation component built in from the start. Preferably, training should be carried out in association with the potential employer and involve an on-the-job component. General training in skills widely in demand (languages, computers) can be considered as well as other alternatives, such as assistance with re-entry to institutes of higher learning. Private sector provision of training should be given priority, and constraints to individuals engaging on their own in such activities must be assessed to minimize the extent to which the intervention may have displacement effects.

### **Policies to Foster the Participation of Women in the Labor Force**

Whether or not women participate in the labor force makes a significant difference in the distribution of family income. Throughout Europe and Central Asia families with low dependency ratios have higher household incomes and a much lower probability of being poor (chapter 2). Women’s labor force participation also has beneficial effects on the intrahousehold

distribution of consumption, reduces women's vulnerability to violence, and improves investments in children.

Prior to the transition, more women in ECA countries participated in the labor force than in almost any other industrialized country. In the Soviet Union in the 1980s, about 90 percent of prime-age women were either employed or went to school (UNICEF 1999). Participation rates for women in Central and Eastern Europe averaged between 65 and 75 percent. These high rates of labor force participation were built, to a large extent, on the availability of government-subsidized child care programs (nurseries, preschool, kindergartens, and after-school programs) in all ECA countries before the transition.

Women's labor force participation rates were expected to decline with the transition to levels more in line with OECD countries. Indeed, between 1989 and 1996 the rates fell by about 12 percentage points in the Czech Republic (for the female population 15 and older); by 8 percentage points in the Slovak Republic; by 12 percentage points in Slovenia; and by nearly 20 percentage points in Hungary (World Bank 1999b, 1999e; Loshkin 1999; Paukert 1998). The drops in labor force participation were not equally distributed across income classes, however, and they disproportionately affected women with little education and skills and from poor households (Loshkin 1999; Yemtsov 1999).

In Russia the decline in female labor force participation rates has been linked to an increase in the cost of child care, especially among low-income families (Loshkin 1999). Loshkin finds that labor force participation decisions of Russian women are strongly influenced by the cost of child care, which has increased sharply with the transition.<sup>5</sup> He concludes that lowering the cost of child care would have a strong positive effect on the labor activity of women and hence indirectly on household incomes. The positive effect of lowering child care costs on household incomes, and hence indirectly on poverty, would be larger than what is obtained via the existing system of family transfers (child allowances).

The link between women's labor force participation, family incomes, and child care (as well as the existing evidence on the positive impact of child care on child development) could justify a renewed role for ECA governments in ensuring that quality care is available for children. Governments need not provide or finance all child care, but they have an important role to play in regulating and providing the right environment for these services to develop. Governments can leverage scarce public resources by supporting existing private and/or informal arrangements and by building partnerships with community groups, nongovernmental and religious organizations, existing social services, and the private sector.

Government also has an important role to play in providing financial support to the poorest families to guarantee them access to affordable child care.

### **Policies to Reduce Discrimination against Women in the Labor Market**

In most transition economies the wage gap between men and women has either fallen or remained relatively stable since the start of the transition. Only in Bulgaria has the gender wage gap increased sharply (by about 5 percentage points since 1989). Controlling for human capital and other job-related factors, we find that the gender wage gap ranges from a low of 11 to 16 percent in the Federal Republic of Yugoslavia, Hungary, and Poland, to a high of 39.5 percent in Azerbaijan (UNICEF 1999).

A number of factors have reduced the pay gap between men and women since the start of the transition. First, since women on average have higher educational attainment than men throughout the region, the increase in labor market returns to education has worked in their favor. Second, there has been a slight trend toward a reduction of occupational segregation, which was high under socialism, again with beneficial effects for women. Countering these positive developments, however, is evidence suggesting that in high-unemployment settings, women may face greater difficulties than men in finding jobs.

A survey of unemployed people in Poland revealed that 40 percent of men but only 25 percent of women found work within a year of becoming unemployed. The main explanation for this gender difference was marital status. Married men were twice as likely to find work as were married women. This reflects women's greater responsibility for child care, which hampers job hunting and may limit employment options, as well as some discrimination by employers (UNICEF 1999).

In part, these discriminatory attitudes may be linked to the high level of mandated maternity benefits in most ECA countries, a policy that may indirectly hurt the employment prospects of married women. Contributing to this discrimination are cultural factors and pervasive gender stereotypes. By shortening the length of mandated maternity benefits and allowing small and medium firms greater flexibility in the level of benefits they offer, governments may reduce employers' reluctance to hire married women. Labor laws in many countries prohibit women from performing certain types of heavy work and from dangerous occupations, which also constricts women's employment opportunities. Modernizing this legal

framework to allow for greater *de jure* equality could help reduce occupational segregation and discrimination against women.

Women seem to suffer more from wage arrears than do men, although this finding appears linked to their higher participation in industries where arrears are common, especially health care, education, and finance. Gender does not seem to be a factor in determining the risk of wage arrears at an individual level, indicating that the decisions of employers and managers related to arrears were not determined by gender bias *per se*.

Overall, there is no clear trend on whether the labor market situation of women has improved relative to that of men, or worsened, during the transition. However, in many countries in the region, and despite constitutional affirmations that women and men are legally equal, women do face some forms of structural discrimination, which spill over into the labor market and into differing opportunities for men and women. One area in which discrimination is particularly strong is family law. The rules of joint property in the Czech Republic and Azerbaijan, for example, do not adequately support women in divorce situations or in nonmarital unions. Laws in Bulgaria, Ukraine, and Armenia actively discriminate against women and fail to protect girls by allowing a lower legal marriage age for girls than for boys.

While the broad legal framework for equality seems to be in place in most countries, there is much to do in terms of making it a reality in the workplace, family, and community. Progress on this front is crucial to ensuring that women and children get a fair share of opportunities and to reducing inequalities between the sexes over the medium term.

### **Policies to Foster Labor Force Participation of People with Disabilities**

Labor force participation rates for people with disabilities are low everywhere in the world. Drawing people with disabilities into the labor force is a stated objective in most countries. Two approaches predominate: economic incentives designed to encourage people with disabilities to work and to encourage employers to hire people with disabilities; and legislation empowering people with disabilities to combat discrimination with the force of law—that is, a “civil rights” approach. The economic incentive approach is based on the notion that disability is a medical condition that reduces productivity. Economic incentives are needed to compensate for lower productivity. The civil rights approach is based on the notion that prejudice and misunderstanding are the greatest obstacles to the em-

ployment of people with disabilities. Legislation is needed to reduce physical and social obstacles that unnecessarily exclude people with impairments. Poland has chosen to rely very heavily on economic incentives, almost to the exclusion of the civil rights approach—without, however, great success. Poland was the first country in the world to implement a “quota-levy” system (box 10.2). The system began in 1920, following the return home of soldiers injured in the Great War.

Quota levy systems still exist in over half of the EU countries, but other countries are moving away from them. The United Kingdom abandoned its quota system and Netherlands gave up on a planned system. Portugal considered but decided against a quota system, and Ireland and Belgium have limited their systems to the public sector. Germany and France reformed existing systems.<sup>6</sup>

Instead, countries in Europe and elsewhere are relying more on antidiscrimination legislation. The flagship for this approach is the U.S. Americans with Disabilities Act of 1990 (together with earlier legislation on civil rights and disability). Australia’s Disability Discrimination Act of 1993 outlaws all discrimination on the grounds of disability. England’s Disability Discrimination Act of 1995 makes it illegal to discriminate against people with disabilities in employment and commerce. Austria, Germany,

### **Box 10.2 Poland’s Experience with the Quota-Levy System**

The quota-levy system currently in place in Poland requires enterprises to reach an employment quota of 6 percent persons with disabilities or to pay a levy. The levy is about 40 percent of the average wage for each person short of the quota. Most enterprises choose to pay the levy rather than hire any workers with disabilities at all. As a revenue-generator, the quota-levy system is a success—it is like a 2.4 percent wage tax. As a mechanism to increase the employment of persons with disabilities, though, it must be considered a failure.

The revenue generated by the quota-levy system, together with generous tax privileges, finances Sheltered Work Establishments (SWEs). At least 40 percent of the people they employ must have disabilities and 10 percent of them must have moderate or severe disabilities. In fact, most people with disabilities employed by SWEs have only slight disabilities—in many countries, they would not be considered disabled. At the end of 1998, 3,100 SWEs employed about 230,000 people with disabilities out of about 700,000 people with disabilities who were employed. SWEs are obligated to spend the subsidies they receive to improve working conditions for employees with disabilities. However, Polish critics of the SWE system argue that it does not encourage inclusion of workers with disabilities into the mainstream labor force and that the money serves mainly to enrich entrepreneurs clever enough to exploit the subsidies. Critics also charge that the SWE system is politically self-perpetuating, because the subsidies to SWEs create the means for disability entrepreneurs to make contributions to politicians who then champion their cause.

and Finland have all amended their constitutions to prohibit discrimination on the grounds of disability.<sup>5</sup>

The economic incentives and civil rights approaches are based on different philosophies, but at least in principle they should complement each other. With proper coordination, each has the potential to make the other more effective.

### Using the Redistributive Power of Fiscal Policy

A key role of governments in most societies is to combat market failure—which includes the inability of purely private endeavor to provide adequate sustenance for everyone in the population. Governments throughout the world have traditionally played an important role in improving the distribution of income and directing resources to the poor. In the centrally planned economies, the state's redistributive role was of central importance. Today, as those economies turn toward the market, the state still has a role to play, albeit an altered one. Indeed, a broad majority of the population of the transition economies believes that the state ought to play such a redistributive role, even in a market-oriented economy. A recent survey of Russian households showed that three out of every four Russians believe that the government should “tax the incomes of the very rich and help the poor” (Ravallion and Lokshin 1999). Similarly, interviews with poor individuals through the region reveal that they believe the state has a responsibility to help them (World Bank 1999a). Many of these individuals, however, have little hope that the state will be able to fulfill that responsibility (box 10.3).

Before the transition the role of the state in all centrally planned economies was similar. Today, however, the size of the state, as measured by the share of public spending in GDP, varies greatly across ECA countries. In much of Central and Eastern Europe, public spending remains large, and in line with that observed in most OECD economies. These large public expenditures, particularly those spent on social programs and transfers, have lessened the inequality arising from pure market-determined outcomes. In contrast, much of the CIS has seen the size of the state shrink dramatically—in some cases to levels incompatible with the delivery of the most basic government functions. This collapse of state spending, along with deteriorating targeting of transfers, has accentuated the increase in inequality.

The apparent correlation between the size of the state and the extent of inequality in the transition economies does not mean that a bigger government is necessarily better for the poor. The impact of public spending

**Box 10.3 Citizens' View of Government in Europe and Central Asia**

Many in the the former Soviet Union believe that the state has abandoned its citizens. The prevalent view of state government in the wake of the Soviet collapse is of a dishonest, uncaring institution. Even in some Eastern European countries, there is nostalgia for the relative egalitarian system of the past.

*Politicians don't care about the suffering population. (Moldova, 1997)*

*People place their hope in God, since the government is no longer involved in such matters. (Armenia, 1995)*

*[The state is] a parent which should take care of its children. (Georgia, 1997)*

*[In the socialist era] there were no such great differences between people, there was no poverty. There was a middle class that lived well. (Macedonia, 1998)*

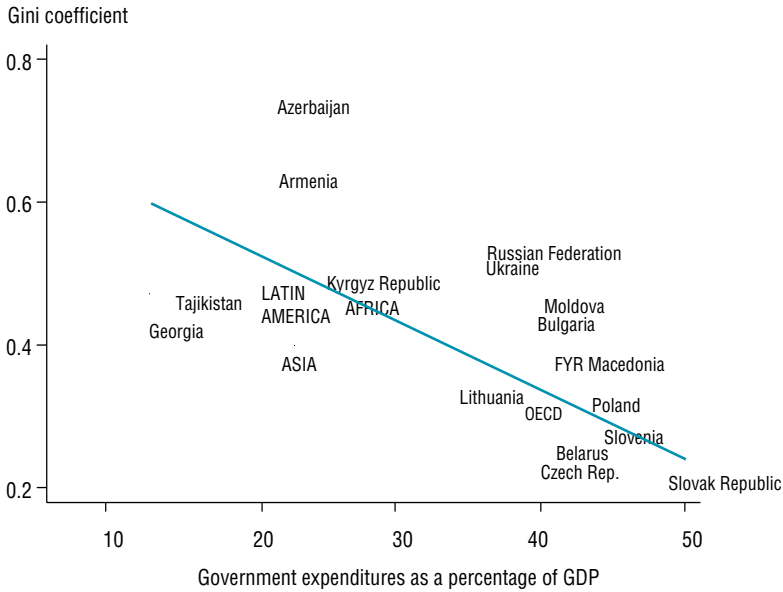
*Source: World Bank (1999a).*

on the distribution of income is not driven by the total amount of resources spent. Instead it depends on the efficiency with which those resources are spent and on how well they are targeted. An extreme example of this can be found in Brazil, which has the largest government in all of Latin America (in line with that of a developed country) and yet the highest inequality in the world. What is different between the CSB countries and those of the CIS is not just that public spending has collapsed more in the latter, driven by the dramatic fall in revenues. The significant difference is that in the CSB the state has been able to use its resources more effectively and deliver its services more efficiently, including that of improving the distribution of income.

Figure 10.3 plots the size of the state, as measured by the ratio of public spending to GDP, against post-transition levels of income inequality. The countries where public spending has shrunk the most are those with the worst distributions of income. This is consistent with the regression estimates in table 10.4, which indicated that the size of government spending had a progressive impact on overall inequality, even when controlling for initial conditions and for progress on liberalization. Interestingly, the effect of government spending was not found to be independent of the government deficit. In fact, the negative impact of government deficits on the distribution of income could swamp the positive expenditure effect.

Figure 10.3 also shows where other regions would fall in the inequality-government spending relationship. This highlights the huge variance in ECA countries with regard to the size of government. Most of the countries of the CSB have spending levels that are well above even OECD standards. The Slavic republics tend to fall between OECD levels of spend-

**Figure 10.3 Government Spending and Inequality in Europe and Central Asia and Elsewhere**



*Note:* The correlation equals -0.71. The observations of the inequality-government spending relationship for non-ECA regions were not used to calculate the correlation and implicit line. They were simply added to this figure for comparative purposes.

*Source:* For Europe and Central Asia, authors' calculations from Dethier, Ghanem, and Zoli (1999) dataset and representative household surveys. For other regions, IADB (1999g).

ing and those of other regions but are notably above the latter. The Caucasus and the poorer countries of Central Asia, on the other hand, stand out for their very low public spending levels, which are below the average for Latin America, Asia, or Africa.

Figure 10.3 suggests that the potential to use fiscal policy as a redistributive tool varies greatly across ECA countries. Tax and expenditure priorities also may be different across countries. Based on this diversity, we can distinguish between three broad groups of countries:

- The countries of Central and South Eastern Europe, where governments are relatively strong and where a broader revenue base suggests that there is significant scope for using fiscal policy to affect the distribution of income;
- The middle-income Slavic republics, the Baltics, and middle-income Central Asian republics, where government is modest in size but where, given improvements in tax collections and better targeting

of expenditures, there is potential for fiscal policy to have some redistributive effect; and

- The low-income countries of the Caucasus and Central Asia, where public spending is currently insufficient for governments to fulfill even their most essential tasks and deliver basic social services. In these countries the focus must be on raising revenues enough to finance a minimum level of government services, including appropriate spending on health and education. The potential for fiscal policy to play a short-term redistributive role is limited, but its importance in preventing the entrenchment of long-term inequality is large.

### Fiscal Policy in CSB Countries

Taxes and transfers have had a significant redistributive impact in most of the Central and South Eastern European countries, and especially in the first round of EU accession candidates (Garner and Terrell 1999; Keane and Prasad 1999; Milanovic 1999). These redistributive policies have played an important role in dampening the increase in poverty and preventing the emergence of large social and income disparities. However, this achievement has not been without costs. Social insurance systems (pensions and unemployment insurance)—used extensively to cushion the impact of large-scale redundancies and protect the elderly from poverty—are running increasing deficits and posing a growing fiscal burden that could threaten macro stability in the medium term. In some countries overly generous systems may be distorting consumption and labor choices and fostering an incipient culture of dependency (chapter 8). Most importantly, by relying on high payroll taxes to support these generous systems, CSB countries run the risk of following in the European Union's footsteps and building a labor market environment that is biased against low-wage and low-skill workers. In much of the European Union, high nonwage labor costs have contributed to high rates of unemployment among low-skilled workers (Dolado and others 1986; Bean and Blanchard 1997; and Bentolila and Revenga 1995). This is a trap that CSB needs to avoid. High tax burdens also pose a disincentive to investment and can ultimately slow down growth.

A fiscal priority in this subregion is to reform social assistance and social insurance systems. The goal is to improve their efficiency and reduce their fiscal costs while maintaining their demonstrated effectiveness at protecting the unemployed, the elderly, the poor, and other vulnerable

groups. Pension reform is at the top of the agenda because of the accumulation of large contingent liabilities in this area. Some of these countries have already introduced multipillar systems quite successfully (Hungary, Poland, and Slovenia); others are in the process of doing so (Romania, Croatia, Latvia, and FYR Macedonia). Another priority on the expenditure side is to streamline social assistance programs, improve their targeting, and introduce work incentives to avoid welfare dependency. There also is scope for improving schemes of help the unemployed, mainly by tightening eligibility criteria, lowering payroll taxes, and distributing the burden more equally between employees and employers. An alternative for countries with less administrative capacity is to opt for one-time severance pay schemes, which are easier to administer and may have less perverse incentive effects.

### **Fiscal Policy in Middle-Income Transition Economies: The Baltics, the Slavic Republics, and Central Asia**

The redistributive impact of taxation in this group of countries seems to be small. In both Estonia and Lithuania, despite fairly high tax compliance, the total redistributive impact of direct taxation amounts to only 1 and 2 Gini points respectively (Cornelius and Weder 1999). Computations for Russia similarly indicate that the total redistributive impact of taxation is modest (Commander and Lee 1998). Although the Russian tax system is progressive on paper and became more progressive during the 1990s, the principal base for taxation is wages, and since its share in total incomes has dropped, so has the distributional impact of taxes. More importantly, the overall effect of taxation is directly conditioned by significant tax arrears, whose incidence is not random but somewhat regressive (Alexeev and Grady 1993).

There is room for making taxation more progressive in most of these republics, particularly through the elimination of tax exemptions, the reduction of tax arrears, and through measures that eventually will increase the share of formal wages in total incomes. But the scope for influencing the distribution of income via progressive taxation of labor earnings may be limited—certainly more limited than in Central Europe. Recent theoretical and empirical research on Chile, for example, suggests that the more unequal the pre-tax distribution, the less the scope for directly improving income distribution via progressive taxes (Engel, Galetovic, and Raddatz 1998). In Russia and large parts of the CIS, tax evasion is a major problem, rendering progressive taxation less effective. Labor

incomes—which represent the part of household incomes most easily taxed and least subject to evasion—are relatively low in all but the top decile. This results in a relatively low average tax rate and relatively little redistribution. It may be more promising for governments to focus on the average tax rate and then target expenditures: high-yield, indirect taxes (such as the broad-based value added tax) may be much more effective at raising revenues and ultimately prove to be more progressive if spending is adequately targeted. The analysis on Chile suggests that distributional considerations should affect only the decision on the size of the overall tax burden. Once this is decided, revenues should be raised with the most efficient tax, and income inequality addressed through the expenditure side.

There is more potential for affecting the distribution of income through expenditure policy. The priority in this regard is to improve the targeting of transfers and make them more progressive. Commander and Lee (1998) and Commander and others (1999) show that the incidence of transfers in Russia (especially pensions) has become more regressive during the transition (with 50 percent of total transfers accruing to the top 20 percent of the distribution). Those transfers that are better targeted, such as child allowances, have become nearly insignificant. The overall effect is to make total transfers regressive: that is, they contribute to increasing total income inequality rather than reducing it. In contrast, in all three Baltic countries, pensions and social assistance are progressively distributed and contribute significantly to increasing welfare and to reducing inequality (Cornelius and Weder 1999; Milanovic 1999).

Improvements in targeting will not be easy to achieve. And efforts to increase the coverage and effectiveness of social transfers must be weighed against existing resource constraints to ensure that programs provide protection without compromising efficiency and growth. There is, however, much scope for improving the efficiency with which resources are used by simplifying schemes and adapting them to countries' levels of income, by improving their administration, and by tailoring programs to groups truly in need (chapter 8).

### Fiscal Policy in the Low-Income Transition Economies

The top fiscal priority in these countries is to increase tax revenues to a level that will allow governments to perform at least their most basic functions. The complete collapse of state revenues in some of the poorer countries of the region has endangered the delivery of basic education and

health services as well as the maintenance of public infrastructure and law and order. Countries cannot provide income-earning opportunities to their citizens without a functioning state. And such a state needs a minimum level of revenues. With revenues on the order of 9 percent of GDP, Georgia provides less than \$6 per capita per year to the public education system. Families with means can make up for the ensuing collapse in quality through private lessons and other informal mechanisms. The poor cannot. This handicaps the earnings potential of their children. In the absence of a minimally functioning state, income and social disparities can become deeply entrenched, passed on from one generation to the next.

The key to raising revenues—more important even than improving administration or lessening corruption—is political will. Weak or captured states may have little ability to enforce tax compliance by politically powerful groups. Therefore, reforms to strengthen the state and reduce state capture are critical (chapter 5). Also promising may be efforts to separate the management and administration of revenues from the political sphere. Georgia's recent subcontracting of customs management to a private company will provide an interesting case study for the region in this regard (World Bank 1999p).

Tax instruments in these countries must be adapted to the level of income. Because of the large informal sectors and low-income levels in these countries, direct taxation is unlikely to yield significant revenues in the foreseeable future. Reliance on high-yield, indirect taxes such as the VAT makes more sense, even if such a consumption tax can appear regressive. As the experience of Chile and other developing countries illustrates, a well-administered VAT can yield high revenues that can be spent progressively, with an overall positive effect on the distribution of income. Like other low-income countries, the poor countries in Europe and Central Asia will need to depend extensively on excise and international trade taxes as a source of revenue. Improvement of customs administration and enforcement is thus critical.

On the expenditure side, the priority in these countries is not to engage in redistributive policies per se but to ensure a minimum level of equal opportunity for all. The highest priority spending must be in education and health to ensure adequate access to and quality of services to the poor. Spending on law and order as well as on basic infrastructure is also of crucial importance to the poor. Given the resource constraints, the scope for using transfers is limited. But small, well-targeted transfers can have an impact. Simulations for Georgia, for example, show that even a modest transfer envelope of 1 percent of GDP, if accurately targeted, can have

a large impact on poverty (World Bank 1999a). Unfortunately, for these programs to work there needs to be a firm commitment from the government to deliver this benefit. Georgia's experience with a very limited poverty benefit has been disappointing. In 1999, only 37 percent of the budget allocated for the poverty benefit was actually paid out to its intended beneficiaries—even though the total planned budget for the program was only 14 million laris, or 1.2 percent of consolidated government spending (0.3 percent of GDP). Actual paid expenditures on the poverty benefit were a miniscule 0.4 percent of consolidated budget spending, or less than 0.1 percent of GDP. Armenia and the Kyrgyz Republic have been far more successful at introducing and operating limited benefit schemes targeted to the poor.

## Notes

1. There are many reasons why inequality can have a direct negative impact on growth. If capital markets are imperfect, inequality can reduce investment opportunities and worsen borrowers' incentives, with negative consequences for growth. High inequality can also increase macroeconomic volatility and hence indirectly affect growth. And greater inequality can create large divergences in interests, which can prevent the adoption of socially efficient policies.

2. Nonfinancial micro-constraints constitute the main barrier to the emergence and expansion of new private enterprises throughout the region. Inflation comes next, followed by lack of financing, corruption, and anticompetitive practices.

3. Arrears fall disproportionately on workers with low wages and little education (chapter 4).

4. Once demand for labor recovers in the CIS, patterns are likely to follow the trend we have seen in Central and Eastern Europe: low skilled and poorly educated workers lose out. As this happens, these policies will gain in importance for the CIS as well as for CSB.

5. According to GosKomStat, Russia's statistical agency, the proportion of Russian children in preschool facilities dropped by more than 50 percent between the mid-1980s and the mid-1990s. This sharp decline in the number of kindergartens and nurseries was accompanied throughout the region by an increase in the cost of government-provided care. Before the transition, childcare costs were typically covered (partially or totally) by subsidies from the federal and local governments or by employers. By 2000, most company-provided daycare services in the CIS had been transferred to local and municipal governments, which usually lack the resources to operate them at all.

6. The material in these paragraphs draws heavily on Metts (2000).

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