Overview

In 1998 an estimated one out of every five people in the transition countries of Europe and Central Asia survived on less than $2.15 per day.[1] A decade ago fewer than one out of twenty-five lived in such absolute poverty. While these estimates are at best an approximation given serious data deficiencies, there is little doubt that poverty has increased dramatically in the region. Moreover, the increase in poverty is much larger and more persistent than many would have expected at the start of the process. Poland is a telling case: poverty has come down steadily from its peak in 1994 as the economy rebounded, yet poverty rates were still higher in 1998 than in 1991.

Absolute poverty in the aggregate is unlikely to diminish in the medium term unless the countries accounting for a large share of absolute poverty in the region, such as Russia, undertake substantial policy reforms that will lead to widespread improvements in living standards. Some countries in the region have moved more effectively than others to tackle poverty. But even the most successful reformers in the region can do more to foster the growth of productive employment, educate their children better to improve their labor productivity in the globalizing market economy, help people cope with the major risks of old age security, health, and unemployment in a fiscally sustainable manner, and address the needs of an emerging underclass of poor.

What is Unusual about Postsocialist Poverty?

The magnitude of the increase in poverty—and its persistence during the past decade—alone would probably suffice to distinguish the experience of the transition countries in the Europe and Central Asia region from other regions. The decline in economic output rivaled that of the Great Depression of the 1930s, and many countries have not yet recovered their pretransition level of GDP. Large as the collapse in living standards is, what truly sets it apart is that it has occurred in the context of profound and far-reaching systemic changes in political, economic, and social life.

On the political front, inhabitants of all but five of the postsocialist countries of Europe and Central Asia have found themselves suddenly living within new state borders, in nations that are fundamentally redefining their identities, and in political systems that in many cases have opened new avenues of political expression and expanded civil rights. On the economic front, transition to a market economy—in many countries not yet fully achieved—has brought new opportunities for many, while for others it has meant unaccustomed material hardship and loss of security. Successive economic shocks—loss of jobs or prolonged nonpayment of salaries, hyperinflation and loss of savings, and the drastic erosion of accustomed supports (such as low-cost or free social services, subsidies, and discounts on goods and services)—have made people feel unusually vulnerable, powerless, and unable to plan for the future.

For most of the new poor, transition has brought not only unaccustomed material hardship, but also the destruction of "normal" life and accustomed social patterns. In contrast to the majority of poor people in developing countries, most of the poor in transition countries are literate, many are well educated, and before the "transition" had secure employment and anticipated receiving regular pensions and allowances from the state after retirement. As jobs are lost and hidden unemployment grows, these sources of support—psychological and otherwise—are breaking down.

The poor expressed deep distress that their knowledge, skills, and formal and informal competencies have become irrelevant. They feel they have lost their sense of belonging to society and are no longer necessary to anyone. Their sense of personal failure, together with the loss of respected social roles and identities, has frequently given way to a paralyzing sense of shame and depression. Increased alcohol consumption, family tensions, and higher suicide rates are some of the manifestations of increased psychological and social stress that have surfaced in consultations with the poor. The psychological pain is as devastating as the material hardship:

"poverty is pain; it feels like a disease. It attacks a person not only materially but also morally. It eats away one's dignity and drives one into total despair" (a woman from Moldova, quoted in Narayan and others 2000, 2).

An important legacy of the past is the shame and stigma associated with being poor. In communist times poverty was largely regarded as a result of individual failings or deviancy, since the state provided guaranteed employment for the able-bodied and assistance to those who were otherwise unable to work. Moreover, the existence of widespread poverty would have been judged as a failing of the socialist state, and so the state tended to suppress any discussion of poverty. This, of course, is changing, but vestiges remain.

At the beginning of the twenty-first century, many of the politically fragile governments in Europe and Central Asia are reluctant to foster a public debate on poverty issues since poverty is on the rise, and nostalgia for the security of the former system is widespread. These factors tend to make societies reluctant to openly acknowledge the existence of poverty in its various manifestations. Experience elsewhere in the world suggests that more open dialogue at all levels of society about the causes and consequences of poverty and inequality helps improves outcomes for the poor. This book aims to contribute to that dialogue. It summarizes what is known about poverty and inequality in the region and explores the major challenges involved in reducing poverty and building more inclusive societies.

The Dimensions of Poverty in ECA

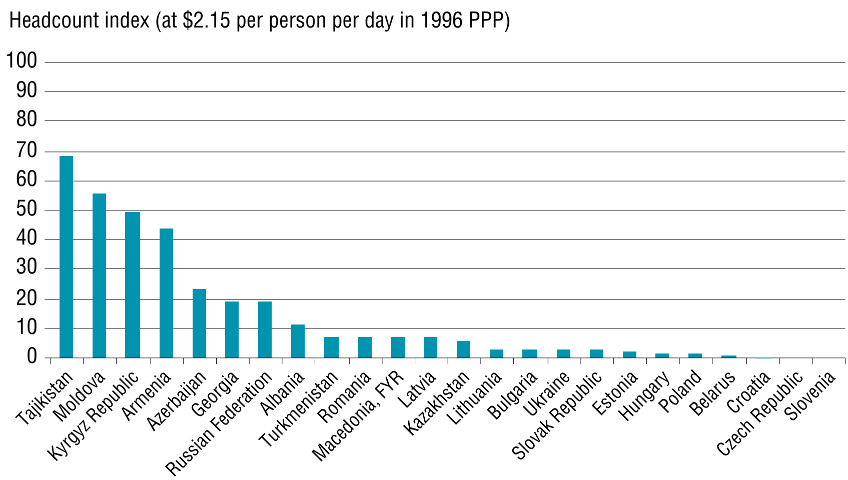
Levels of absolute income deprivation—measured by the $2.15 a day per person poverty line in 1996 PPP terms—vary considerably across the region, with the highest levels found in the Central Asia and the Caucasus region (figure 1). Based on the $2.15-a-day measure, there is virtually no absolute deprivation in many Central European countries. In contrast, the incidence of absolute poverty in Russia is close to 20 percent. The Russian poor accounted for about 60 percent of those living in absolute poverty in the region in the late 1990s. As a measure of absolute deprivation, the two-dollar-a day poverty line is preferred to the one-dollar-a-day line used in some other parts of the world because of the additional heating costs necessitated by the very cold winters prevailing in much of region. It also is at the bottom end of the range of national poverty lines, expressed in PPP terms, of the poorer countries in the region.

Although measures of absolute deprivation are useful in deriving regional estimates of poverty, they tell us little about the levels of resources individuals need to live with dignity and respect in a particular country. For this reason countries usually establish their own national poverty lines. These national poverty lines tend to increase with a country's income level. Therefore, even though the level of absolute deprivation based on the two-dollar-a-day line is very low in some Central European countries, poverty does exist in these countries, and it is a serious concern—just as it is in the United States or Western Europe. In the United States, for example, the poverty line for a family of four in 1998 was set at $11.41 per person per day. It was originally calculated in the mid-1960s as three times the minimum basket of food a family would need and since then adjusted for inflation. At this line, the official poverty rate in the United States in 1998 was 12.7 percent.

A Profile of Poverty in the Region

Despite some notable similarities, transition countries in ECA vary substantially in a number of ways, including their income levels, demographic profiles, degree of urbanization, pattern of labor market adjustment, and scope and targeting of public transfers. As a result, the pattern of poverty might be expected to vary across countries. But surprisingly, these patterns are quite similar across the region.

Figure 1 Percentage of Population Living in Absolute Poverty in ECA Transition Countries



Source: Chapter 1, table 1.1.

Three major risk factors stand out: employment status, age, and location. First, employment status: not surprisingly, households with a head that is unemployed or inactive have a higher risk of poverty, relative to the rest of the population. Unemployment levels are correlated with education levels, and as a result people with only a primary school education have a higher risk of poverty than do people with a secondary education or higher. Second, age: in most countries, children are at a much higher risk of poverty than are the elderly, contrary to popular opinion. Likewise, the more children a household has, the higher its relative risk of poverty, even allowing for some economies of scale in consumption. Having more mouths to feed puts multichild households at higher risk of poverty, but lower levels of adult labor force participation also work to their disadvantage. Third, location: in most countries the rural population has a higher risk of poverty than the urban population, though there are a few exceptions, notably Ukraine.

Ethnicity is also a high risk factor in some cases. Although poverty data disaggregated by ethnic status are very limited, survey evidence for a few countries in Central and South Eastern Europe confirm that poverty rates for the Roma far exceed those of the overall population. In Hungary, for example, the Roma are about eight times more likely to be in long-term poverty than the general population (World Bank 2000a).

The unemployed, children, and rural populations have the highest relative risk of poverty, but in most countries they do not comprise a majority of the poor. The typical poor person is more likely to be between the ages of 15 and 64 and to live in an urban area in a household whose head is employed. Only in a few countries in Central Europe, where the relative risks of poverty are especially high for children or the rural population, is the typical poor person likely to be a child or live in a rural area. There are also a few countries in Central Asia where the majority of the poor are either children or rural residents, but this reflects these groups' large share of the population more than their high relative poverty risks.

Economic Insecurity

Another dimension of poverty is economic insecurity. If people are living on the margin of poverty, fluctuations in their incomes could easily push them into poverty, especially if they have few assets to rely on to smooth their consumption. As in other parts of the world, in Europe and Central Asia there is a high degree of volatility in incomes and consumption. One consequence is that there is a lot of movement in and out of poverty over time. Panel survey data from Russia, for example, show that the share of the population that has experienced at least one bout of poverty is more than double the fraction of the population in poverty in any one year; for Poland and Hungary the share is slightly less than double.

Although many households experience expenditure shocks—and some fall into poverty—many of those shocks are undone in subsequent periods. Over a long time horizon, economic positions are more stable. Stripping away the fluctuations and looking at the underlying pattern of expenditure reveal that poverty status is far more persistent. About 80 percent of those in the bottom quintile of the expenditure distribution in Poland, Hungary, and Russia remain stuck there. This more persistent picture of poverty is consistent with the long duration of unemployment, particularly in Central Europe. It appears that an underclass is forming, and with it the threat of long-term, structural poverty. Safety nets are needed to help people cope with temporary poverty in ways that do not dampen their incentives to earn income, but a potentially even more serious issue is how to improve the prospects of those with few opportunities to better their life chances.

Material deprivation and income insecurity are particularly important dimensions of poverty in Europe and Central Asia, given the fall in income and profound change in economic structures defining the transition process. The concept of poverty, however, goes beyond material deprivation. It encompasses poor health and lack of education as well as other nonmaterial dimensions of well-being, including powerlessness and social exclusion. Because of the positive achievements of the past, the poor in ECA fare much better than the poor in other parts of the world in terms of their education and access to health care. But there are signs that these past achievements are being undermined by cutbacks in the delivery of health and education services and, even more importantly, by the widespread rise in under-the-counter payments demanded by public service providers.

Deteriorating Health and Education Systems

School enrollment rates in ECA countries are significantly higher than those typically found in countries of similar income levels. Even in the poorest transition economies, primary school enrollments exceed 85 percent, and in many countries primary enrollment is effectively universal. Unfortunately, enrollment rates have started to fall in some of the poorest CIS countries: from more than 90 percent in 1989, primary school enrollment rates have fallen by about ten or more percentage points in Moldova, Armenia, Georgia, Turkmenistan, and Tajikistan during the past decade. In addition, there are signs of declining school attendance. The available evidence, sketchy as it is, suggests that poor children are the most likely to drop out of school or attend sporadically, and the least able to afford the costs (clothing, textbooks, transportation) of going to school.

The decline in funding for educational materials, unpaid teachers' wages, and lack of heat and maintenance for some schools contribute to a decline in the quality of schooling. Regional disparities also appear to be a problem in some countries, reducing the opportunities for children in poor rural areas to get a quality education. Moreover, as their salaries have fallen in a number of countries, some teachers have resorted to supplementing their incomes through tutoring—effectively requiring students to pay for tutoring to be awarded a passing grade. Parents also are being asked to pay bribes to obtain entrance to specialized schools for their children. These forms of corruption effectively result in unequal opportunities for children from poor families.

On the health side, indicators for the region are also far better in most cases than in countries of similar incomes, reflecting the universal provision of comprehensive health care services to consumers and high levels of education. Maternal mortality rates are low, ranging from less than 10 per 1,000 live births in Central Europe to less than 30 per 1,000 live births in Central Asia (with the exception of Turkmenistan), and they declined significantly between 1980 and 1987. Rises in under-five mortality rates have largely been contained. Even in the poorest countries in Central Asia, most children continue to be immunized, despite cuts in public expenditures on health.

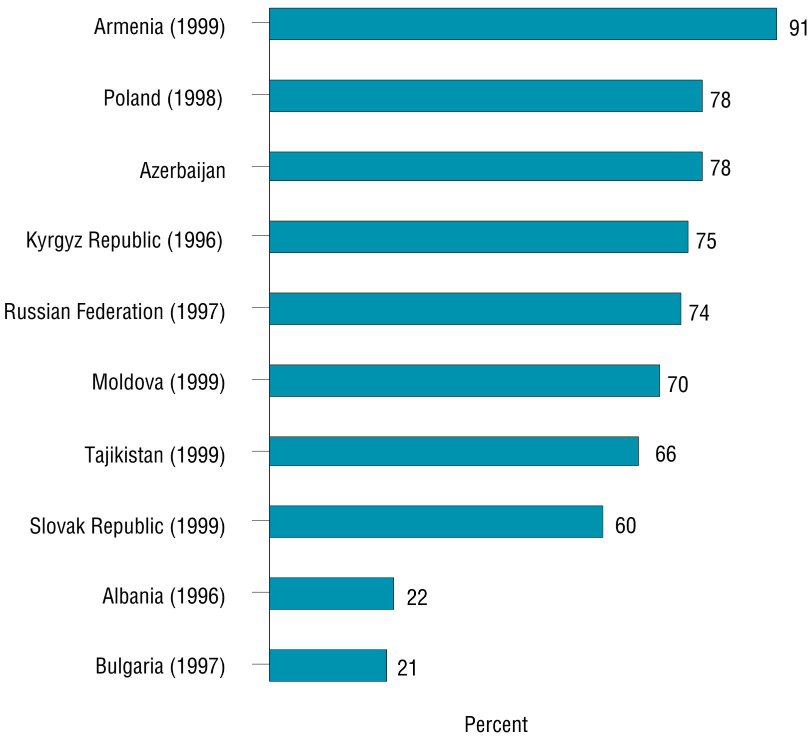
Notwithstanding the relatively favorable indicators, disturbing health problems are surfacing. Most widely commented on has been the decrease in male life expectancy, particularly evident in many, though not all, of the countries in the former Soviet Union (FSU). Male life expectancy fell by around four years between 1989 and the mid-1990s in the Baltic countries and by more than five years in Russia, Ukraine, and Kazakhstan. By 1994 male life expectancy in Russia had fallen to 58 years—with a significant share of the decline attributable to the almost 100 percent increase since 1989 in the mortality rate of males between the ages of 40 and 59. Not all countries experienced a drop; life expectancy remained almost constant in Armenia and Turkmenistan. There has been a lively debate about reasons for the increase in deaths. The proximate cause is an increase in cardiovascular and circulatory diseases and accidents and violence. Psychological stress in response to the difficulties of transition—which appears to have led to an upsurge in excessive alcohol consumption—may have contributed to excess deaths from these causes. Mortality increases were lower in areas where social support systems were stronger.

Diseases such as tuberculosis that had been largely controlled are now staging a resurgence, along with an explosion in sexually transmitted diseases and the related threat of an HIV/AIDS epidemic in parts of the region, most notably in Eastern Europe. Ukraine, Belarus, Moldova, and Russia have the highest rates of HIV infections, with 1 percent of the adult population of Ukraine estimated to be living with HIV/AIDS. In Russia the number of reported HIV cases quadrupled between 1998 and 1999, largely among injecting drug users. The skyrocketing increase in sexually transmitted diseases suggests that in the future HIV is in danger of spreading into the mainstream population through sexual transmission. Tuberculosis, including more drug resistant forms of the disease, also increased during the 1990s. In Russia survey-based rates of drug resistant TB are among the highest in the world. TB is neither diagnosed reliably nor treated effectively, because of a lack of drugs and the use of nonstandard treatment protocols. If HIV becomes more widespread in the general population, it is likely to fuel a parallel increase in tuberculosis.

Less widely recognized—but with potentially serious implications for child development—are signs of emerging nutritional deficiencies. Malnutrition is a concern: in several parts of the Caucasus and Central Asia, wasting and stunting exceed WHO-determined threshold levels. The reemergence of iodine deficiencies, which leads to goiter, is another serious concern, especially because of the risks it presents of severe mental retardation. Salt iodization programs, the principal way of eliminating iodine deficiencies, appear to have broken down in some countries, leading to a rise in goiter rates. Goiter rates now approach 80 percent in parts of the Caucasus and Central Asia.

While there is little hard evidence showing that health outcomes for the poor are more negatively affected than the rest of the population, it is clear that access to health care is becoming increasingly dependent on whether a household can afford the "informal" payments to doctors and others practicing in collapsed public institutions (figure 2)—and that the poor have the least ability to pay. In some countries, notably the Caucasus, informal payments account for more than 85 percent of all expenditures in the sector. The poor sometimes go without medical care or drugs, or they sell off their income-generating assets to scrape up the cash needed to get treatment. The loss of access to free health care is of considerable

Figure 2 Share of Patients Making Informal Payments in Selected ECA Countries



Source: Chapter 8, figure 8.3.

concern to the poor and near poor and contributes deeply to their sense of growing vulnerability.

Growing Social Strains

The stresses of the transition are evident in many indicators. Families are no longer stable: divorce rates have increased in the Western CIS and Estonia, while marriage and birth rates have declined sharply throughout the region. Children and young adults are increasingly at risk. Poverty has led to an increase in the number of institutionalized infants ages 0 to 3, while a growing number of children are living on the street. In Russia alone the number of street children is estimated at one million. Youth unemployment is high in many countries, teen pregnancies have sharply increased, and the increase in unprotected sex has made young people vulnerable to sexually transmitted diseases including HIV/AIDS. Suicides of young males increased by more than 50 percent between 1989 and 1997 in Russia, Belarus, Lithuania, Slovenia, and the Czech Republic (UNICEF 1999); trafficking in young women is on the rise; and young men in the poor rural areas of Central Asia are increasingly being recruited into the drug trade. These trends presage the emergence of major social problems that threaten to complicate future efforts at poverty reduction.

Consultations with the poor reveal a decline in social cohesiveness. Poverty has reduced their ability to participate in informal networks of self-help. At the same time the consumption of the rich has become more conspicuous, fueling social tensions. The poor see the rich as people who have gotten where they are by exploiting their connections and by profiting dishonestly from their official positions. As one poor woman observed, the rich "have been plundering everything and eating so much that they cannot carry their own stomachs." Corruption, indifference, and ill treatment by those in power pervade virtually every aspect of the lives of the poor, whether it is dealing with social assistance and pension offices, obtaining health care, trying to run a small business, or seeking help from the police. Throughout the region the poor perceive the state as having effectively abandoned them. As one Georgian said: "Our leaders announced transition to new market relations and then left us to the mercy of fate, not asking whether we were prepared to accept the transition" (Dudwick 1999, 20).

Explanations for the Increase in Poverty

The main explanatory factor for the emergence of poverty in Europe and Central Asia is the social and economic dislocation of transition, and the resulting drop in output, government revenues, and household incomes. The impact of this economic collapse was accentuated by a large increase in income inequality. Coming as it did when incomes were falling, the increase in inequality meant that those at the bottom of the income distribution received an even smaller share of a shrinking pie.

Although they can account for much of the quantitative rise in poverty, these two factors—the collapse of output and increasing inequality—are in some sense just proximate causes, behind which lies a complex interaction of economic, social, and political processes. Both the extent of the output collapse and the rise in inequality were influenced by many interrelated factors: the degree of initial macroeconomic distortions, the familiarity of institutions and individuals with market mechanisms, the inherited economic structure, and the comprehensiveness and quality of the policy reform package. Most importantly, the path of output and incomes was conditioned by institutional legacies, which largely determined the behavior of policymakers during the transition and their interest and ability to deliver a consistent reform program, with adequate safeguards to protect the vulnerable.

The Fall in Output

The decline in output was pronounced throughout the region, but much more so in the CIS countries, where poverty has also risen the most. On average, the cumulative output decline in the CIS countries was almost 50 percent, while in the CSB (Central and South Eastern Europe and Baltic countries), output declined by about 15 percent before starting its recovery. The size of this output collapse is linked both to initial conditions and the choice of reform path. Less favorable initial conditions—larger economic distortions, less familiarity with market mechanisms and institutions, and less political reform—typically led to worse output performance. Yet while initial conditions are important, the choice of policies, and especially the comprehensiveness and quality of economic reforms, seem to have mattered even more. Some countries with highly unfavorable initial conditions have done well because they implemented strong reform packages, while others that started from a more favorable situation have done poorly. Overall, countries that implemented inconsistent or partial reforms experienced a larger drop in output than did those that reformed more quickly.

More importantly from a poverty perspective, these partial reformers experienced a sharper rise in poverty, for a given drop in output, than did countries that implemented more comprehensive reforms. This was mainly because inequality in these incomplete and partial reformers increased much more. People have mainly experienced the impact of the output collapse as a change in paid employment and in what wages can buy, and as a fall in government transfers and services.

Declining employment. All transition economies have experienced a sharp drop in the demand for labor. Falls in output across the region have entailed large declines in employment and wages. These effects have been amplified by the need to improve productivity and reduce the labor hoarding common to the old system. Most countries have also witnessed a decline in labor supply, as participation in the labor market has dropped because of early retirement, discouragement, or women choosing to stay at home. In all the transition countries of the region, the share of the population employed today is significantly smaller than it was at the start of the transition.

In most of the CSB countries, open unemployment rates are high and persistent. While the employed are benefiting from rapidly rising productivity and wages, the jobless—and especially the long-term unemployed—risk being left behind. Despite the strong resumption of GDP growth, job creation remains sluggish. The recovery of output has not resulted in much growth in net aggregate employment. Differences in standards of living between those with jobs and those without them are large and growing. Poverty is closely linked to unemployment.

In the CIS countries the decline in GDP was so abrupt and sizable that equivalent cuts in employment were politically and socially untenable. Enterprise restructuring has been limited, and the reduction in real wages or nonpayment of wages has been the dominant mode of labor market adjustment. Registered unemployment is low, but definitions based on household surveys suggest much higher rates of actual unemployment and inactivity. Hidden unemployment, with workers retaining formal ties to an enterprise but neither working nor receiving a wage, is also high. Yet income opportunities outside these attachments to nonviable and low-paying enterprises appear to be few. New private sector activities that could attract these workers have been slow to emerge, largely because of the incompleteness of reforms. Given the lack of alternatives, many families have turned to subsistence agriculture, or other forms of small-scale self-employment, to supplement their meager formal incomes. As a result, labor is channeled to these low-productivity activities rather than to new, higher-productivity jobs. GDP growth—where it has happened—has not brought about a recovery of employment levels. An extreme case of this is Armenia. Despite five years of continuous positive growth (averaging 5.2 percent per year) between 1994 and 1999, employment declined by 8.5 percent.

Shrinking fiscal revenues and transfers. The collapse in GDP also entailed a collapse in state revenues throughout the region. For many of the CIS countries, this was compounded by the loss of large fiscal transfers from Moscow as a result of independence. What happened to revenues dictated to a large extent whether countries were able to take action to cushion the social impact of the transition. Many of the CIS countries simply did not have the fiscal space to maintain basic social transfers—in some cases not even pensions. Many also had to slash spending in health and education, contributing to the spread of informal and under-the-table payments and hurting the poor more than the rich. Poor budget management and implementation in the face of shrinking revenues also led to the emergence of pervasive arrears in public sector payments, wages, and pensions in parts of the CIS (for example, Georgia, Moldova, Russia). These arrears have had a highly regressive aspect, since they fall disproportionately on the poor and are highest in poor regions.

Could fiscal adjustment have been carried out in a different, more propoor way? There is little doubt that, at least in the CIS, the quality of fiscal adjustment could have been much better. Across-the-board cuts in expenditures, with a bias toward cutting social and infrastructure spending, contributed to worsening inequality, and hence to increasing poverty. The absence of a safety net made it hard to restructure and lay off workers, and this contributed to slowing down growth and lengthening the recession. Moreover, by increasing inequality, these cuts may have contributed to slower growth. They certainly made it more difficult for necessary market-supporting institutions to develop: cash-starved governments that cannot pay their civil servants will find it impossible to develop an effective and accountable public administration and regulatory bodies.

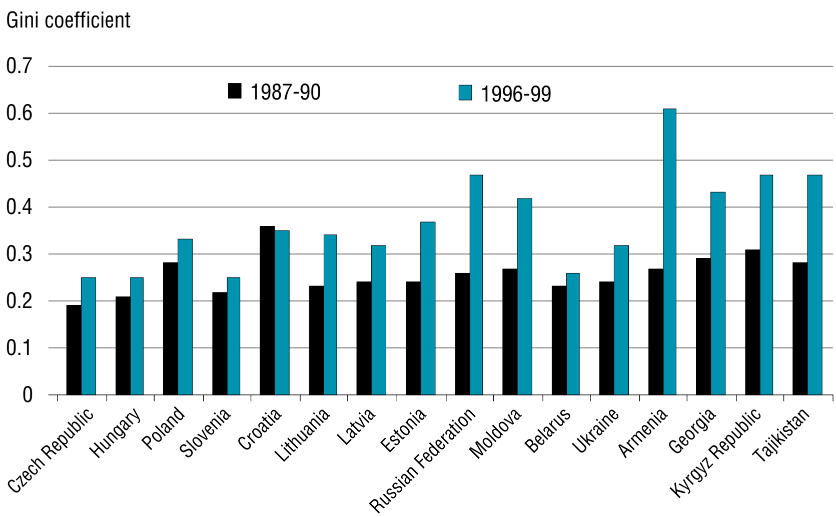
In contrast to the CIS experience, expenditures in CSB countries were kept at very high levels. High levels of expenditures, especially in the social sectors, helped cushion the impact of the transition and made reforms more acceptable. In Poland, for example, pensions were critical to preventing the elderly from falling into poverty. In this manner high expenditures in the CSB may have been crucial to maintaining support for reforms and hence to the recovery of growth. The challenge for the CSB countries right now is how to reduce the fiscal burden imposed by these high levels of social spending without undermining their positive protective impact.

Rising Inequality

The collapse in output was critical in determining what happened to poverty. But what has happened to inequality has been equally important. The countries of Europe and Central Asia entered the transition process with some of the lowest levels of inequality in the world. But since then inequality has increased steadily in all transition countries—and dramatically in some of them (figure 3). Countries like Armenia, the Kyrgyz Republic, Moldova, and Russia are now among the most unequal in the world, with Gini coefficients nearly twice their pretransition levels.

The rise in inequality is in part attributable to positive developments: rising returns to education, a decompression of wages, and returns to risk taking and entrepreneurship. Despite the resulting increase in inequality,

Figure 3 Changes in Income Inequality in Selected ECA Countries during Transition



Source: Table 4.1.

these forces are welcome because they signal that the market is now working to reward skills and effort, as in more mature market economies. In the CSB countries, the rise in education premiums and wage dispersion has been dampened by strong social transfers and redistribution, in line with the demands that these societies have placed on their governments for such mechanisms. This has not been the case in the CIS, where social transfers have at best been negligible and in some instances even contributed to making inequality worse.

Rising educational premiums and wage dispersion are not sufficient to explain rising inequality in the CIS and, in fact, explain surprisingly little of it. Much of the rise in inequality in the CIS must be attributed instead to the apparent collapse of formal wages and income opportunities, the pervasiveness of wage arrears, and the resulting explosion of self-employment as the main source of household incomes. Unlike in the CSB, however, this emerging self-employment does not reflect new, private business activity but rather a large-scale move toward subsistence agriculture—a last-resort coping strategy to keep households afloat. New, formal job opportunities in the CIS are scarce, stifled by the lack of competitive markets and the pervasiveness of corruption and bribe-taking. People, except for a privileged few, are largely stuck in their low-paying (and sometimes nonpaying) jobs. Access to connections and informal networks, and an ability to pay, are key to finding a job and getting ahead. This has led to highly unequal outcomes.

Although these developments can explain the rise in inequality in the CIS, they are not the root of the problem. They are rather the manifestations of the failure to carry through with reforms aimed at the public good as a result of the state's capture by private interests. Those whose incomes depend on the continuation of opportunities for asset-stripping, monopoly rent-seeking, illegal enrichment, and tax evasion are a powerful force against policies that would foster widely shared prosperity. They have a strong interest in blocking further reforms that would allow for a true transition to a market economy and a more equal distribution of opportunities and incomes.

The Role of Institutions

Why were some countries so much more successful than others in managing the transition in a socially responsible way? And why were some countries more susceptible to capture by private interests from the start? The answer lies in the institutional structure these countries inherited, and the resulting incentives power holders faced to break with the past. Countries with stronger institutional checks and balances (resulting from stronger civil societies, more mature political democracies, and more developed market-supporting institutions) were better at establishing economic and political contestability from the start. As a result, these countries implemented more pro-poor policy choices: they carried out more comprehensive and decisive reforms, moved more quickly toward a market-based system for allocating resources (and away from the power- or access-based system that characterized late socialism), and carried out more socially focused adjustment. Because they were better at getting markets to work, these countries generated more new job and income-earning opportunities for their citizens. At the same time they also gave higher priority to keeping a strong social safety net and devoted a much larger share of their resources to this goal. Poverty and inequality increased, but much more moderately than in other parts of the region.

Other countries, most notably those of the CIS, failed to establish economic and political contestability. The partiality and incompleteness of economic and political reforms during the first stage of transition simply allowed some power groups—mainly traditional socialist elites in combination with some entrepreneurial newcomers—to cement and legalize the power relationships that existed at the end of socialism. In the absence of institutional checks and balances or other measures to restrain the arbitrary use of power, these groups were able to generate concentrated rents for themselves at a high cost in terms of increased inequality and poverty to the rest of society. These power groups are now the main obstacles to any further economic reform that would threaten their concentrated rents. With rent-seeking channels now firmly "institutionalized," politicians in much of the CIS are reluctant to let the process of democratization and market expansion move further, since this may jeopardize the status quo.

The partiality of the initial reforms—especially the lack of further efforts to deconcentrate economic power and create better-functioning markets—has stifled job creation and opportunities for all but these privileged parts of society. Formal wages and employment opportunities have collapsed, and with pervasive noncompetitive practices and corruption to contend with, there is little room for new small- and medium-scale private activity to emerge to create jobs. Resource-starved governments have revealed only limited interest (and ability) to protect the vulnerable: social spending has collapsed throughout much of the CIS, and along with it so has the social safety net. The result has been a virtually unprecedented increase in poverty and inequality.

Public Action to Reduce Poverty

Social and economic policies can go a long way to create opportunities, reduce poverty, and bring about a more egalitarian society—provided there is a political consensus for such policies. Such a consensus is unlikely to exist when institutions are not effective and do not act in the interests of the broad electorate. They are unlikely to work well when state capture or corruption are pronounced. Politicians captured by special interests have little incentive to advocate policies in the interest of all in society, including the poor. Public servants who earn their living through side payments for services rendered have little interest in forgoing corrupt practices. Captured and corrupt states are unlikely to "correct" themselves unless pressure comes from nonstate institutions and actors.

Building Institutions to Support Poverty Reduction Strategies

How can state capture and administrative corruption be tackled? The key is to address the underlying problems of institutional capacity and incentives faced by the state, civil society, and the private sector through a multipronged approach focused on increasing the cost of state capture to politicians and reducing the benefits from state capture to firms. There are five key building blocks: (a) increasing political accountability; (b) strengthening institutional restraints; (c) strengthening civil society participation and media oversight; (d) creating a competitive private sector; and (e) reforming public sector management. Increasing the transparency of the political process and political competition will make leaders more accountable to voters. Political participation by all segments of society can work to improve distributional equity, and it can improve social outcomes in health and education. Strengthening institutional restraints requires building and reinforcing the horizontal separation between the legislative, executive, and judicial branches, and turning them into legitimate and competent state institutions. The poor have much to gain from a well-functioning legal and judicial system and professional law enforcement, since police harassment, lawlessness, corruption, and violence deeply affect their daily lives. Building an effective public service is a key element in the strategy to reduce administrative corruption, and it can have a large impact on those most dependent on public service provision, the poor.

Once a state is captured, pressure must come from civil society and nonstate organizations, such as citizens groups, nongovernmental organizations, trade unions, religious organizations, and from the media. Long repressed during the socialist period, civil society will take some time to develop—especially where NGOs and other groups and the media are closely identified with government interests. Increasing economic competition will help dissolve the concentration of economic interests—though such a policy is likely to face strong resistance. Here, too, pressure from civil society will be key.

But even in states with governments that are not captured or corrupt, the poor are often voiceless, and their interests figure little in public policy. What can be done to increase their opportunities to make their concerns heard? One step is the creation of a concept of true public service, which when combined with mechanisms to monitor whether public servants are serving their clients effectively can help ensure that programs designed to serve the poor actually deliver their intended benefits. Another important advance is to ensure that the poor are made aware of their legal rights to receive benefits and public services, and have an effective means of redress if those rights are abrogated. Decentralization (a means of putting public officials in closer touch with the concerns of local populations) may give the poor greater opportunities for voice, provided issues of accountability and transparency are addressed.

Measures to build the social capital of the poor can play an important part in their empowerment. Reconstructing and empowering civil society, constructing new bases for community and social cohesion, and decentralizing government institutions are particularly important in ECA, given the devastating impact the strongly centralized, authoritarian socialist regimes had on "community" and "society." Where state capacity to deliver services is weak or absent, building accountable, inclusive local-level institutions can serve an important role. Yet such efforts are fraught with pitfalls: where local-level power structures are highly unequal, decentralization can increase exclusion and hurt the poor; widespread cynicism about public authority and politics and a tradition of alienation may slow down the development of civil society; the strong lack of community identity in many parts of the region—or identification with a social network that excludes other groups on ethnic or clan-related or other grounds—may work against the construction of an inclusive community able to act effectively on its own behalf. Building inclusive community-based institutions will not be fast or straightforward. But it may be the best hope for fostering the creation of national-level and state institutions that serve the broad interests of society—and are inclusive of, and accountable to, the poor.

Better-functioning and more inclusive institutions will facilitate the implementation of policies aimed at the broader public good, but even the best-intentioned governments will need a well-thought-out and coherent strategy to deliver improvements in living standards. Making transition work for everyone means first and foremost improving people's opportunities to earn a living through productive work. In turn, this means that everyone, including the poor, must have the capabilities needed to take advantage of those opportunities. Education and health systems must be reformed so that the poor as well as the rich can participate fully in the market. Making transition work for everyone also means providing for those who cannot participate in the market and helping citizens reduce the economic insecurity they face. In the past, socialist societies strongly emphasized security at the expense of individual achievement. Many citizens today want government to play an active role in providing for those who have no means of supporting themselves and in reducing the risks of inadequate income in old age and loss of income from employment. The challenge is how to do so in a way that is consistent with the fiscal resources available and does not dampen incentives to create new jobs. Governments can play an active role in reducing inequality and enhancing the mobility of those at the bottom—not only for reasons of social justice but also to foster social cohesion and long–run prospects for growth.

Creating Opportunities

Growth—and with it the generation of employment opportunities—is a sine qua non for poverty reduction. Living standards in very poor countries cannot be improved without growth. Provided it is equitably shared, growth can have a big impact on poverty reduction. In Poland, for example, the mean expenditures of the poor fall some 20 percent short of the relative poverty line—reflecting relatively shallow poverty. A 10 percent increase in mean income, equitably distributed, would reduce the incidence of poverty by 35 percent. But in Russia, by contrast, the incomes of the poor fall more than 30 percent short of the poverty line—hence deeper poverty. The same increase in mean incomes would reduce poverty by only 20 percent, far less than in Poland but still a respectable amount. In aggregate, absolute poverty could be reduced by more than 50 percent over a ten-year period if the region were to grow at 3.7 percent per year and that growth were to be shared evenly among the population. Were aggregate growth to be somewhat lower—2.7 percent per year—and inequality to worsen by 20 percent, however, poverty might actually increase in the region.[2] These simulations underscore the importance of robust, sustainable economic growth that is widely shared across the population. But this is far easier said than achieved.

While growth is essential to a continuing improvement in living standards, what matters ultimately is that growth generates jobs and that real wages rise over time as labor productivity increases. High unemployment rates and declines in labor participation rates in the CSB countries, and the considerable labor hoarding and low productivity prevalent in the CIS countries, suggest that job creation is likely to lag economic growth for some time to come. Even in the more successful reformers, such as Hungary and Poland, employment growth has lagged output growth by a considerable (and increasing) margin. In Hungary, for example, the number of jobs in 1997 was 30 percent lower than in 1989, even though output had recovered to its 1989 level. If the countries of the OECD are any guide for these economies, increasing the "job content" of output growth and tackling unemployment will require measures that go well beyond making the labor market more flexible. Increasing the flexibility of housing markets, deregulating product markets, and breaking up infrastructure monopolies are likely to be as important. Those measures are the key to the emergence of a competitive private sector that can be the engine of growth and rising labor demand.

Although some countries are on the road to growth, prospects are more uncertain in others. The challenges differ depending on where countries are in their reform efforts and on their income levels. Broad cross-cutting themes, however, are relevant to all countries First, fiscal adjustment remains central to the macroeconomic stabilization and growth prospects of all countries—and to poverty reduction efforts—since economic and financial crises are harmful to the poor. But the quality of that adjustment is paramount, if the state is to play its role in ensuring that all citizens have the capability to participate in the market and protect the vulnerable. Second, the enabling environment for private sector development—the key engine of job creation—remains deficient across the board. Third, virtually all countries face the problem of providing adequate social protection for those affected by economic restructuring. This, of course, is linked to the fiscal resources available, thereby closing the circle on the key set of needed reforms.

The more advanced market reformers have largely attained aggregate fiscal discipline, but they face quality issues in terms of managing off-budget fiscal risks generated by explicitly and implicitly guaranteed loans by government. Pension systems have threatened to undermine fiscal sustainability in many of the advanced market reformers as the ratio of contributors to dependents has fallen substantially over the transition period and will continue to fall. Pension reform is under way in many countries to reduce the burden on the budget and on contributors. This will help keep jobs in the formal economy, the number of covered workers high, and the future secure for senior citizens of today and tomorrow.

The less advanced market reformers have not yet achieved sustainable aggregate fiscal provision. This will require continuing efforts at revenue enhancement and expenditure retrenchment, with a particular focus on commitment control so that all expenditures are made on time and in cash. Key here will be inter- and intrasectoral budget tradeoffs, particularly with regard to the health and education sector, which accounts for a large share of budget spending. Soft budget constraints on the enterprise sector need to be eliminated in all their forms, because they not only compromise the tax and fiscal effort but also undermine restructuring and future growth prospects.

Although the advanced market reformers have made significant progress on the privatization and enterprise reform agenda, they still face challenges. They now confront the difficult challenge of privatizing infrastructure and utilities monopolies to bring in the new investment needed to modernize these sectors and maintain a competitive edge in the global economy. But for privatization to be successful, an appropriate legal and regulatory framework needs to be in place. Similarly, while the more advanced market reformers have in place the basic elements of frameworks for enterprise liquidation and insolvency, corporate governance, competition and antimonopoly policies, and regulation of the banking sector, these frameworks are sometimes deficient in key respects and inadequately enforced. The less advanced market reformers face the same challenges in improving the institutional structure that governs private sector activity. However, in addition, the enabling environment for small business remains sorely lacking, with excessive government micromanagement and corruption a major issue in many countries.

Moving ahead on the land reform agenda and promoting agricultural growth more broadly will contribute to overall growth and poverty eradication, especially in the low-income countries. Smallholder agriculture is more productive and labor intensive than is the newly privatized state and collective farm sector. While all countries have embarked upon agricultural reforms, considerably more progress must be made, especially in the areas of farm restructuring and liberalizing of marketing arrangements. Input markets are not functioning well in parts of the region. Governments may need to determine where this problem is attributable to excessive government interference and corruption and where there are more genuine market failures—for example, in the area of rural credit—in which they might usefully play a role.

Imposing hard budget constraints on enterprises and continuing the privatization process will increase the claims on the budget for severance payments, unemployment insurance, and other social assistance measures. Combined with measures to promote entry of new firms, this will generate a more productive economy over the medium term and over the long term more jobs. Considerable restructuring of the social sectors, including downsizing of personnel, will also be necessary to improve health and education services for the poor. But in the short term these measures may aggravate poverty. Freeing up fiscal resources to finance social assistance measures will be difficult, given the competing claims on the budget—hence the importance of improving revenue collections and prioritizing expenditures.

Improving Capabilities

To ensure that growth will be inclusive over the long term and to avoid the intergenerational transmission of poverty, ECA countries will need to pay particular attention to improving capabilities. While much has been achieved in this area under socialism, there are major deficiencies in health and education systems that affect much of the population, and especially the poor. Across the region people are increasingly being called on to make side payments to publicly financed health care providers. This is also a problem in the education system. Most governments have avoided making the tough decisions required to rationalize the intrasectoral allocation of expenditure within the two sectors as real social sector expenditures collapsed along with GDP. Personnel are underpaid or not paid at all, complementary expenditures (on materials, drugs, heat, and repairs, for example) are underfinanced, and the number of facilities and personnel significantly exceed OECD benchmarks. A major reallocation of expenditure—and greater accountability—is needed to ensure that governments can deliver on their commitments to provide universal primary education and basic health services to the population. Without a reallocation of funds, some of the poorest countries in the region risk not being able to provide universal primary education and essential health services. Rationalizing personnel and facilities, and allocating more funds where necessary, would help put both sectors on a sounder financial footing. In turn, this could eliminate the conditions that give rise to the "informal" payments that are rationing the poor out of the system at present, assuming there is government commitment to stamp out this form of corruption.

Beyond this lies the challenge of bringing the quality of the education and health systems up to OECD standards. Despite substantial achievements in these areas, neither system delivers high-quality health or education services. For the most part, education systems have not been adapted to prepare people for a modern market economy, which requires the ability to apply learning to new situations, rather than narrow specialization. Health systems have some ways to go in applying the most up-to-date treatment protocols and encouraging their population to change behaviors that lower adult life expectancy.

But these reforms are unlikely to fully address questions of differential access of the poor. The state, for example, may want to subsidize poor children's attendance at preschool programs. To keep their children in school, very poor parents may require additional assistance offsetting the loss in income children earn when kept out of school. And as cost-recovery measures are put in place for tertiary education, scholarship programs for the poor need to be instituted. Ensuring that the poor get access to health care entails deciding on the type of national health program to implement and how coverage for the poor will be financed. Of major importance to the poor is coverage for catastrophic illness—which they can least afford to pay for.

Reducing Destitution and Increasing Security

The key social protection challenge for most countries is to help the truly destitute and ensure that children do not suffer long-term developmental damage or fail to gain access to schooling and other opportunities for lack of funds. Once these objectives are met, societies can provide protection against adverse economic outcomes to a much broader range of the population. The challenge is to provide the right amount of social protection. Too much protection is fiscally costly and entails major disincentive effects, while too little protection may give rise to socially unacceptable levels of destitution and may irreparably harm children. Striking the right balance between protection and efficiency concerns is difficult for most countries, but it is especially tough in transition countries. First, as noted earlier, the choices between efficiency and protection are not clear-cut: higher expenditures on social protection programs to facilitate the reallocation of labor to more productive uses may serve long-term efficiency objectives. Second, the political challenges of reforming social protection systems are formidable. The socialist system provided a high degree of security that the public continues to want. For this reason, poor transition countries often have a more developed set of social protection programs than do other countries of similar income levels.

Despite the emphasis that has been placed on social protection measures, they have had only limited success in reaching the poor. Many countries spend about 1 percent of their income on social assistance programs, and even where they spend somewhat more, these programs for the most part have been poorly targeted, have covered only a limited number of poor, and have made little difference in their economic circumstances. Recent evaluations show that social assistance reaches only 2 percent of the poor in Latvia, for example. In some cases the bottom quintile gets only its share of total spending on social assistance, while in the best cases the bottom quintile receives roughly 40 percent of total spending. Thus, the bulk of spending is not going to the poorest.

In a number of countries, especially in the CIS, a great deal of money is spent subsidizing utility consumer prices–often by the utilities themselves from their capital budget—but most of this spending does not go to the poor, entails significant price distortions, and has deprived utilities of funds needed to maintain their infrastructure. The biggest chunk of social protection spending has gone to social insurance programs, especially pensions. Pensions have played a major role in helping countries (especially in

Central Europe) cope with transition shocks, reduce poverty in pensioner households, and dampen inequality.

A major challenge is to improve the targeting of social assistance programs and utility price subsidies. In all countries the priority should be the provision of adequate protection to the truly destitute and children at risk. But it is not easy to find cost-effective ways of doing this. In the poorer countries where poverty risks are not often well differentiated, categorical-based benefit systems are not likely to be well-targeted or to achieve high coverage—if they are affordable. Community-based benefit delivery might be used in conjunction with a transparent, interregional benefit allocation formula, especially in the poorer countries. Such programs might be supplemented by self-targeted programs, including work-fare schemes, which offer below market wages to avoid disincentive work effects. Middle- and high-income countries have the resources, financial and administrative, to adopt more universal, means-tested programs. Of particular concern for these richer countries are the high rates of poverty in multichild households, which ought to be a major focus of social protection programs. They also need to address the problems of socially excluded populations—in particular, the long-term unemployed and ethnic minorities such as the Roma.

Pension spending is high in transition countries, especially relative to income levels. The aging of the population—which will further reduce the number of contributors relative to the number of recipients—makes it all the more imperative to put pension systems on a more sustainable basis over the long term. The main public pension reform option in middle- and high-income countries is to tighten the benefit-contribution link, downsize public systems in order to reduce the burden on the budget, reduce contributors' tax rates, and create room for a funded program that would eventually supplement the publicly funded system. Low-income countries cannot afford the pension systems that they have—and hence they have let extensive pension arrears develop. In the short term it would be better to move to a flat distribution of payments that are paid on time. As economies grow and the contribution base widens, the benefits could be differentiated in line with contributions.

To deal with growing unemployment in the early years of transition, many countries initiated unemployment insurance programs similar to those in OECD countries. These programs proved to be expensive, not only because they had very generous benefits, but also because unemployment was high and persistent. Countries tightened provisions and often let benefits erode with inflation. While the programs may have helped cushion the shock of transition, they are not sustainable as they are. Unemployment insurance programs are more relevant for countries that can finance benefits at low tax rates, can administer benefits well, and can collect contributions attributed to individuals. Only some of the higher income transition countries are reaching this stage. Lower income countries may want to convert their unemployment insurance programs—which are not meeting their objectives—into unemployment assistance programs financed from general revenues and focused on flat-rate layoff packages, and coordinate them better with other social assistance schemes.

Reducing Inequality and Improving Mobility

Governments can also play an active role in reducing inequality and enhancing the mobility of those at the bottom. The main motivation for this may be social justice and a desire to maximize social welfare. But there are also other reasons for societies to be concerned about levels of inequality. For example, the existence of capital market imperfections combined with high levels of income inequality may effectively prevent equal educational opportunities. There is also evidence that high levels of inequality may threaten social cohesion, thereby deterring new investment and lowering long-run growth prospects.

While some increase in inequality as a result of transition was both anticipated and welcome—insofar as it provides incentives for risk-taking and hard work—the magnitude of this increase in some countries is worrisome: it raises doubts about the ability of some segments of society to participate fully in economic, social, and political life in the future. The agenda of policy actions described earlier that further the objective of transition are by and large consistent with a strategy to reduce inequality. Improving tax compliance—a major issue in most CIS and South Eastern European countries—would not only improve the fiscal situation and capacity for inequality-reducing transfers, but also could in itself help to reduce inequality. The aforementioned social assistance programs are a powerful tool for redistributing income to those at the bottom. Redistributive fiscal policy can also play a role in fostering the accumulation of public capital and promoting educational opportunities in poor rural regions in the higher income countries. In addition, many of the reforms described under the growth agenda—including further deregulation of the product market and financial sector development—will help reduce inequality. This is an important message because the popular perception is that market development and liberalization raise inequality. But the evidence for ECA suggests that this need not be the case.

Various other policy measures are often considered by societies that are committed to a more egalitarian distribution of income. Some can work, but others come at high cost. For example, policies to raise the wages of unskilled or low-skilled labor include those that establish a minimum wage or wage floor and those that facilitate investments in human capital and increase the productivity of the unskilled. The evidence from other regions suggests that minimum wages may lead to some decline in inequality (and somewhat larger positive effects on poverty), but they carry well-known risks, including a potentially negative effect on employment. Therefore, such policies are to be approached with caution. Training programs can also be used to provide workers with new skills better suited to the market economy. Evaluation of the effectiveness of training schemes for unemployed workers in three transition countries (the Czech Republic, Hungary, and Poland) found generally positive, though small, employment effects. Women and young workers benefited more than did male and older workers. While such programs may have a role to play in economies that are well advanced on structural reforms and are growing, they will do little to solve the problems in only partially reformed economies where the fundamental problem is collapsed labor demand. Policies that foster labor market participation of women may reduce poverty as well as having other beneficial effects, including reducing women's vulnerability to violence and increasing investments in children. The link between women's labor force participation, affordable childcare programs, and higher household incomes justifies a renewed focus on childcare—especially if it can be tied to early childhood education programs that improve the life chances of poor children.

Conclusions

Widespread poverty in transition countries in Europe and Central Asia need not be a permanent phenomenon. Economic and social policies have been effective in reducing poverty elsewhere in the world and could be effective in ECA—if governments choose to pursue them. Building public institutions that are accountable and responsive to a broad electorate is a prerequisite for more effective poverty reduction strategies. This, in turn, is linked to the development of a vibrant civil society in which information freely circulates and channels exist for making preferences known. Spurred in part by the prospects of accession to the European Union, some countries are moving quickly in that direction. But even in these countries, the poor may have little direct voice in shaping the interventions that affect them on a day-to-day basis. Effective poverty reduction strategies will entail removing the barriers to their equal participation in the market and in political life.

For countries where powerful private interests have captured the state, the challenge is particularly great. The cost of inaction is much higher as well, since these are the countries where the majority of the poor are found. It is essential to reduce state capture and make public institutions more broadly accountable. Societies can then confront the difficult challenges of expanding opportunities for productive work, improving the capabilities of the poor so that they can participate in the market, and providing the destitute with the basic essentials of life. Only then will transition work for everyone.

Notes

1. These estimates (World Bank 2000b) are based on 1993 PPP rates. Figure 1 reports the most recent available estimate of poverty by country, based on the newly available 1996 PPP rates, which are better for estimating poverty outcomes in the second half of the 1990s. Estimates based on the 1996 PPP rates are *not* comparable to estimates based on the 1993 PPP rates.

2. These projections are based on a $2.15 poverty line in 1993 purchasing power parity (World Bank 2000b).

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