1-1-2003

Income and Influence: Social Policy in Emerging Market Economies

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Citation
Kapstein, Ethan B., and Branko Milanovic. 2003. Income and Influence: Social Policy in Emerging Market Economies. Kalamazoo, MI: W.E. Upjohn Institute for Employment Research. https://doi.org/10.17848/9780585469676

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W.E. Upjohn Institute for Employment Research
Kalamazoo, Michigan

Library of Congress Cataloging-in-Publication Data

Kapstein, Ethan B.
Income and influence : social policy in emerging market economies / Ethan B. Kapstein and Branko Milanovic.
p. cm.
Includes bibliographical references and index.
ISBN 0-88099-269-7 (pbk. : alk. paper) — ISBN 0-88099-270-0 (hardcover : alk. paper)
1. Income distribution. 2. Social policy. 3. Poor. 4. Mixed economy. I. Milanoviâc, Branko. II. Title.
HB523.K36 2003
339.2′2—dc21
2003004903

300 S. Westnedge Avenue
Kalamazoo, Michigan 49007-4686

Cover design by J. R. Underhill.
Index prepared by Nairn Chadwick.
Printed in the United States of America.

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Preface

Social policy has only recently emerged as a significant topic of analysis and debate in the context of economic reform in developing countries. During the early days of the so-called "Washington Consensus" on economic reform, which corresponds roughly with the late 1980s and early 1990s, experts asserted that macroeconomic stabilization, market liberalization, enterprise privatization, and openness to world markets would provide the underlying conditions needed to produce sustained growth, the tide that must ultimately lift all boats. But even in those countries that have most rigorously applied the Washington Consensus formula, the outcomes for working people have been decidedly mixed. Poverty, inequality, and unemployment remain widespread around the world, with little prospect for amelioration.

As a consequence, the relationship between economic reform and social policy (usually defined in terms of social assistance and social insurance, which is our main focus, but sometimes more broadly to include policies for public health, housing, and education as well) has now emerged as a major issue for international financial institutions and the broader public policy community. The World Bank, for example, has devoted itself to "a world free of poverty," and its year 2000/2001 *World Development Report* (World Bank 2000/2001) deals with that very topic. For their part, development economists have been engaged in research programs that seek to understand the domestic and global factors that drive changes in poverty, inequality, and unemployment. This focus on social policy has arisen for several complementary reasons beyond any purely humanitarian motives. The reasons include growing worries over the political sustainability of economic reform, fears that social problems in developing countries could spill over to the industrial world in the form of greater migration, and concerns with the spread of infectious diseases, such as AIDS.

This book seeks to contribute to the ongoing debate over the role of social policy in emerging market and postcommunist transition economies, with a focus on Latin America, East Asia, and the former Soviet bloc. Specifically, we argue that poverty reduction has *not*, in fact, been the major objective of social policy in these countries, or even necessarily of the international financial institutions that are important providers of loans and advice to them. Instead, the main purpose of social safety net programs has been to help smooth the consumption patterns of those formal sector workers who feared that economic liberalization would reduce their incomes and job prospects. It is these workers who have lobbied their governments most vigilantly for social insurance, and it is their concerns that have been at the top of the domestic social policy agenda.

Our argument is that the pattern of social policy we observe in developing countries is determined by two major factors: the domestic political influence of formal sector workers, who provide the greatest potential roadblock to reform, and the absolute income level (GDP per capita) of the emerging market economy in question. Specifically, poor people in poor countries receive little in the way of social benefits not only because they lack political influence, but because their governments lack the income to provide them with a safety net. As countries become richer, they also become more capable of providing social insurance, and the recipients of government largesse tend to be those who are politically well organized; that is, workers in the state sphere or in the major industries. Social policy is thus a function of income and influence.

The two programs of greatest concern to these groups, pension reform and unemployment compensation, have also been topics of great interest to the World Bank and the International Monetary Fund, although it should be emphasized that these institutions are not always in agreement about policy design. Pension reform has been extolled by many public officials and academics as the magic bullet that can simultaneously stimulate capital markets, create financial service industries, promote privatization of industry, and stabilize government budgets, while also performing its core function of providing an adequate retirement to the aging population. Unemployment compensation, while once viewed as largely irrelevant as a policy instrument given the particular labor market context found in most developing countries, has also been the subject of renewed interest, especially following the Asian financial crisis of 1997–1998.

But the challenges facing developing countries in the implementation of social policy are many, and they appear almost overwhelming. Beyond the fiscal weaknesses that most of these countries face, including widespread tax avoidance and capital flight, severe administrative limitations must also be confronted. Further, advancing certain policies such as pension reform requires the creation of entirely new institutions, such as independent regulatory bodies and financial markets, that in turn rely on other institutions, like the rule of law, which may be very weak. In short, throughout the developing world, social policies must be introduced in the context of limited state capacity, yet meet the rapidly rising demand for social insurance and assistance.

There are five chapters in this book. Chapter 1 presents our argument about the relationship between economic reform, changes in income distribution, and the demand for social policy, placing it in the context of the theoretical literature on the welfare state. In Chapter 2 we analyze the data on income inequality and globalization. We focus on openness for three reasons: 1) because it has probably been the single economic change that almost all emerging market economies, including those in Latin America, Asia, and Eastern Europe, have sought (or been urged) to adopt in recent years; 2) because the relationship between globalization and income inequality has become the topic of an important research program in economics; and 3) because proxy measures of openness are relatively easy to operationalize, in comparison with some other measures of liberalization. The third chapter examines the three major economic crises of recent decades that have prompted renewed interest in the process of economic reform, structural adjustment, and social policy: the Latin American debt crisis of the 1980s, the postcommunist transition, and the Asian financial crisis. In Chapter 4 we focus on the two most influential social policy innovations to emerge from the developing world, Chilean pension reform and unemployment insurance in Korea. The final chapter provides our conclusions and policy recommendations.

In writing this book, we have accumulated many debts to individuals and institutions around the world. It is not possible to list them all individually, but we hope that they will see their contributions in the finished product, and many of them will find their names and published works listed among the references. But we do wish to express our thanks to the W.E. Upjohn Institute for the grant that made the project possible, and to the University of Minnesota, INSEAD, the French Institute for International Relations, and the World Bank for logistical and administrative support. At the Upjohn Institute, Susan Houseman, Kevin Hollenbeck, and two anonymous reviewers of the manuscript deserve special thanks. Allison Hewitt Colosky did an excellent job editing the manuscript and greatly improved our original submission. Despite all the assistance we have received from friends and colleagues, we must assume responsibility for any errors that remain.

1
Social Policy in Emerging Market Economies

Designing social policies for the world's emerging market economies has become a prominent topic on the global agenda. The 1995 World Summit for Social Development pledged the international community to the goals of poverty reduction and full employment, and in recent years the international financial institutions have taken up the knitting of social safety nets as one of their core functions. Turning these ambitious pledges into concrete actions received strong impetus following the Asian financial crisis of 1997–1998. In a background note written for a meeting of the World Bank/International Monetary Fund (IMF) Development Committee at that time, the authors stated, "A system of social protection is a central ingredient of public action to help provide safeguards against adverse shocks" (World Bank/IMF Development Committee 1999).

Despite the expansive rhetoric about social policy, important questions remain about its implementation.[1] Most developing countries lack the budgetary and administrative resources to launch ambitious new programs of social protection, while the weaknesses of fiscal policy make it difficult for governments to redistribute public benefits to those at the bottom of the income distribution. Moreover, the political influence of the poor is limited. In short, issues of governance and political economy loom large in the design and execution of social safety nets.

We argue in this book that economic liberalization, particularly policies associated with greater openness, have increased the demand for social policy in emerging market economies. This is *not*, however, because the process of reform has produced some neat, "once and for all" division of winners and losers, such that social policy can be cleanly targeted at the latter by means of lump-sum compensation payments. That model of economic adjustment is rarely found outside academic journal articles. In practice, who wins and who loses from these policies varies not only across countries but also over time. In the middle-income emerging market economies which provide our focal point—mainly those found in Latin America, East Asia, and Central and Eastern

Europe—we would argue that the winners and the losers may in fact be one and the same group, depending on the time horizon that is adopted.

Specifically, we argue that for those skilled and semiskilled workers who are found in the upper deciles and who work in the formal sector, economic reform brings with it a serious downside, at least over the medium term, as restructuring and market opening lead to job displacement, unemployment, and greater economic insecurity. These workers are thus particularly vulnerable to the changes wrought by economic liberalization, including shifts in the terms of trade, and they have the greatest fear of falling into the lower economic classes. This group may enjoy, relatively speaking, the greatest rewards from economic reform in the long run, but they also face the greatest risks of downward mobility more immediately. As a consequence, these are the workers who have lobbied most strongly for social insurance programs, and who have been the main beneficiaries of social policy reform. Indeed, the concerns of these groups have resonated both domestically and internationally. In short, it is the relatively privileged income groups in middle-income countries that have won the lion's share of the social policy benefit; the poor in poor countries have seen little by way of social insurance or assistance, in part because they are politically weak, and in part because the countries where they live have extremely limited budgets. This argument is summarized in Table 1.1.

The significance of social policy has likely risen with the spread of democracy as well. Domestically, the consequences of economic reform have been challenged at the polls, as well as outside the electoral system in the form of organized opposition, such as strikes and riots. Social policy schemes have thus been introduced as a way of winning political support from the most affected groups; they have not, as a general rule, been targeted at the poor. Internationally, the "globalization" of many of the problems associated with the absence of effective social policies, including increased demand for migration, has led officials in the North and in international organizations to believe that market-oriented reforms must be complemented by attention to social safety nets. For example, Juan Somavia, the Director General of the International Labor Organization (ILO), has warned that "the global economy is not creating enough jobs," inevitably leading to greater pressures for migration. Greater attention to "socio-economic security," he argues, and to improved coordination between social and economic policies, would make for a more success-

Table 1.1 Social Transfers, by Income and Influence

Relative income level within country	Country's GDP per capita level: Low	Country's GDP per capita level: Medium or high
The poor	Nothing	Some assistance
The middle class	Very limited social transfers (primary education)	Extensive social protection (education; health; pensions; family benefits; unemployment)
The rich	Some social transfers (pensions; education)	Extensive social protection (education; health; pensions; family benefits; unemployment)

ful reform strategy (Somavia 2002). As economist Dani Rodrik has written, social insurance "cushions the blow of liberalization among those most severely affected, it helps maintain the legitimacy of these reforms, and it averts backlashes against the distributional and social consequences of integration into the world economy" (Rodrik 1999).

Despite this increase in demand for social policy, developing countries and transition economies confront a variety of special challenges in designing and implementing programs that are effective and efficient. The World Bank (2001) reminds us that, "[t]he state may well be the best agent to provide insurance, but lacks the necessary institutional strength, financial resources, or management capacity." Governments will also face difficult political economy issues in structuring these programs, given that "[t]he political support to allocate resources may also be lacking, since it requires getting the rich to support a program that does not benefit them." In sum, the emerging market economies are subject to a particular set of constraints in meeting the needs of their uneducated, unemployed, poor, aged, and sick populations.

This chapter situates our argument about the political economy of social policy within the context of the broader literature on the welfare state. While the European welfare state (and its North American variant) has been the subject of a major research program in social science for many years, social policy has only recently joined the academic pantheon as a major topic for students of economic development and reform (for overviews see Graham 1994; Chu and Gupta 1998; and Ghai 2000). These programs—including pensions, unemployment compensation, and other income transfers—did not figure prominently in the early iterations of the so-called "Washington Consensus" model of reform, which focused on price liberalization, macroeconomic stabilization, and privatization of state enterprises. In part, this was due to a widespread belief among economists that "strong medicine" would produce sustained growth, resulting in high rates of employment and wealth creation, and making the focus on social policy largely unnecessary (Williamson 1994; Rodrik 1996; Kapstein 1997). And in certain regions, especially East Asia, it appeared to many observers that specific cultural values and deep wells of social capital made the formation of welfare state institutions irrelevant if not counterproductive.

Clearly, two recent events, coupled with the earlier experience of the Latin American debt crisis, have shattered that optimistic view: the transition of former Soviet bloc economies from communism to a market orientation, and the Asian financial crisis of 1997–1998. The economic transition, which has plunged millions into poverty and has even been associated with shortened life spans in several countries, including Russia, has been labeled "a cruel process" by the United Nations (UNDP 1999), while the Asian crisis is said to have produced, in the words of ILO's Eddy Lee, "widespread social distress" (Lee 1998).

The magnitude of these crises naturally provoked immediate responses on the part of public officials and nongovernmental organizations, and it also caused academics to reconsider some of their theories of economic development and reform. But did these shocks *cause* social policy to rise on the public agenda of developing countries and international institutions? Or were other, deeper forces at work that spurred a growing demand for social safety nets? These questions lead us to consider some of the alternative theories of social policy development.

THEORIES OF SOCIAL POLICY AND THE WELFARE STATE

Despite the apparent correlation between recent crises and the renewed attention being given social policy, there are in fact at least six different causal theories, not necessarily mutually incompatible, as to why social issues have come to occupy such a leading place in contemporary discussions of economic development and policy reform. It is important to emphasize that disagreements remain about the specific causal mechanisms that give rise to public demand for government-provided social schemes, as well as over the incidence or distributive consequences of such spending. In part, these disagreements reflect data limitations and a lack of hypothesis testing, but strongly held normative views have also shaped this research program. The main views are as follows.

First, some scholars have suggested that the process of economic reform has had dramatic distributive consequences within societies, and that the "losers" have demanded compensation in the form of welfare state policies as the price for their (tacit, if not active) political support. In this view, income transfers are the necessary domestic complement to policies of market liberalization, and in their absence a backlash against reform will occur. Social policy is thus part of a grand bargain between national governments and society. (For a review of the literature, see Kapstein 2000.)

An associated argument holds that a larger welfare state is necessarily associated with increasing economic openness. The underlying hypothesis here is that as countries open themselves to the world economy, their industries and workers face terms-of-trade risks against which only governments can provide insurance. This is particularly the case for small economies. Confronted by increasing economic volatility, the workforce demands social safety nets as the *quid pro quo* for a more open trade policy. Further, to the extent that openness promotes greater income inequality, as many researchers now agree that it does (while still debating its exact impact), voters may demand redistributive social schemes as a way of redressing the balance. Supporting these theoretical arguments is the empirical finding that open economies tend to have bigger governments (Rodrik 1997).

A second perspective is fundamentally humanitarian and cosmopolitan, focusing on the consequences of the economic shocks of recent decades for the lowest income quantiles, especially in developing countries. These shocks led to sharp increases in poverty and unemployment, overwhelming existing insurance schemes, both formal and informal. A host of social problems are associated with these economic problems, including rising crime and, in some regions (notably the transition economies), a dramatic worsening of public health. Captured on global television, these humanitarian crises have mobilized nongovernmental organizations, such as Cooperative for Assistance and Relief Everywhere and Catholic Relief Services, to provide emergency assistance, and to act as lobbyists for their cause. In response to growing public pressures, industrial world governments and international financial institutions have come to recognize their responsibility in the face of humanitarian crises; in some countries, the provision of aid to those in need has even been deemed a worthy new task for post–Cold War militaries. In short, this view asserts that the recent attention paid to social policy arises out of a concern for the well-being of citizens not only exposed to the ravages of natural disasters of various kinds, but who have been hurt by economic reform and structural adjustment as well (Lee 1998; Lumsdaine 1993).

A third view also emphasizes the role of international institutions in managing the process of globalization, but this perspective is more technocratic. In its benign variant, these institutions are portrayed as having learned from history about what makes for successful adjustment and reform programs, and have recognized the need to incorporate social policy into this process (Finnemore 1996). In its malign form, these institutions are viewed as tying their conditional lending programs to harsh austerity programs that throw workers into the street. A minimal social safety net is offered to these workers out of a *realpolitik* calculation on the part of "global capitalism," in which these institutions, of course, serve as mere lackeys.

A fourth perspective focuses on democratization and the demand of newly empowered voters for greater social spending (Brown and Hunter 1999; Birdsall and Haggard 2000). A growing body of political economy literature hypothesizes that democracies are likely to promote welfare state institutions for two reasons. The first is due to the preferences of the so-called median or middle-income voter, who may not have the economic means to protect herself against possible downturns in her fortunes, and will seek to promote public sector programs for unemployment insurance, health care, and pensions by taxing the rich. A related theory focuses on the role of organized interest groups, such as labor unions and retired persons, and the political voice they gain in the process of electoral and policy contestation. Both of these approaches lead to the expectation that as emerging market economies democratize and become older, political pressures for the further development of social insurance programs will increase.

A fifth theory, prominent in the welfare state literature, sees the rise in social policy as inextricably linked to the process of modernization and industrialization; in this view, the developing countries are largely mimicking a process earlier experienced by today's advanced economies (Lindert 1996). The causal argument is that, as these processes unfold, workers leave behind the family and kinship networks that previously helped to maintain them during hard times in the rural sector. In the absence of these informal safety nets, the state acts to provide the support system, and in so doing, the government acts on behalf of the modernization process and of industrial capital. These economic factors, when combined with growing electoral contestation, appear to have played an important role in the evolution of the European welfare state; they seem to have been less influential in shaping the East Asian social contract.

In a related vein, rising incomes may also lead to a greater demand for social insurance. In this model, welfare programs may be conceptualized as a luxury good that people buy as they become wealthier. Lindert (2000) has provided some support for these arguments in his econometric research, observing that the richer the country, the greater the share of its GDP spent on social insurance. Further, he observes that public sector social spending is a fairly recent phenomenon, with particularly rapid growth since the end of World War II from a relatively feeble 19th century base. Prior to that time, it was the Church and other charitable organizations that took the lead in welfare provision.

Finally, in the economist's parsimonious view, social policy simply reflects the failure of markets to provide people with the assistance and insurance they may wish to buy in order to meet the risks with which they are presented. These market failures could be due, for example, to information, adverse selection, or covariance problems. For whatever reason, the private sector refuses to sell the insurance that is demanded, and the government steps in to provide it.

Let us explore each of these theories in turn.

The first perspective is closest to the political economy approach we adopt in this book. It emphasizes the distributive nature of economic change, including market liberalization. Our research indicates that economic reform, particularly policies associated with trade and financial opening, has created a demand for transfers to those groups most vulnerable to fluctuations in their income stream, and not necessarily to those in poverty. In this regard we emphasize that the two social policies that have received the most attention from the international community, pension reform and unemployment compensation, are the programs of greatest concern to this “striving class” of workers.

The second view, focusing on humanitarian concerns, posits that social policy is mainly designed to counteract the effects of poverty and extreme vulnerability. We do not believe that there is much evidence to support that contention in developing countries. As the IMF economists have written, the weak fiscal features of developing countries, including widespread tax evasion, “cast doubt on the ability of tax policy to redistribute income” (Chu, Davoodi, and Gupta 2000, p. 3). Nor have the international institutions fared much better in targeting their aid programs. There is thus a sharp distinction to be drawn between the emergency relief programs provided to political and economic refugees or victims of natural disasters, and “the poor” as an income group. While humanitarian motives may explain relief efforts, we do not see much of a spillover effect in the form of permanent redistributive measures to help those in the lowest-income quantiles.

The third perspective, emphasizing the role of international institutions, brings with it significant insights. Most historical analyses of the welfare state have emphasized the role of national actors and institutions in policy development. Less attention has been paid to international political, economic, and, perhaps most important, ideational pressures (but for a partial exception, see Kapstein 1999; Deacon 1997; and Gain 2000). We agree that this represents an important gap in the literature, and it is one that we address in this book.

To flag our argument, we contend that international institutions may promote social policies *directly* by financing, through their lending schemes, insurance schemes in particular countries, and *indirectly* by transmitting ideas about what constitutes sustainable economic policies for growth. As we will show, agencies like the IMF and the World Bank have negotiated social policy reforms as part of the conditionality agreements struck with developing countries, and the role of these policies has apparently grown over time, reflecting a change or evolution in views about their importance.

The fourth position, linking democracy and social policy, also has a growing body of evidence to support it, and it may be viewed as complementary to the position we emphasize. After all, if voters and organized interest groups can influence policy choice, it is largely because of the exigencies—the “pushing and pulling”—associated with democratic politics. But we would add as a caveat the reminder that many different regime types, including military governments, dictatorships, and communist regimes, have also engaged in social policy reform and the provision of universal social benefits. That historical fact suggests that the literature on modernization and industrialization, as stated in the fifth view of the welfare state, also contains some critical insights into the emergence of social policy around the world.

Finally, the economic perspective highlights market failure and the demand for state-provided welfare services. By this logic, it may be argued that, as a general rule, individuals should cover risks that are of an idiosyncratic nature, or those associated with their particular behavior. In contrast, risks that are common to large groups of citizens usually cannot be financed out of an individual’s pocket, and instead must be pooled more widely. Where the risk is to an entire nation or to a large segment of it, the state may be expected to provide the requisite insurance in its entirety.

In reality, of course, we find significant deviations from these general principles. To take an obvious case, it could be argued that old age is the sort of “risk” that every worker has an entire lifetime for which to prepare, and thus should motivate workers to save for it out of their annual earnings. Yet almost every industrial country provides its aging population with a public pension and medical insurance of some sort. Similarly, it is not obvious why many governments are in the business of providing health care insurance to their citizens, since private firms could theoretically sell coverage to beneficiaries; but here too we find that the industrial states have come to occupy a large role in subsidizing medical treatment, and in some countries, like the United Kingdom, medicine has been largely withdrawn from the private sector and instead has been “socialized” (Barr 1993).

The specific incidence of social programs suggests that more than economic calculations of efficiency or market failure are at work when such policies are devised and implemented. Exploring the political conditions under which the welfare state emerged has thus occupied a generation of historians, political scientists, and sociologists. As of yet, their research has failed to produce a consensus or unified field theory with respect to the causal forces that have shaped the formation and subsequent development of social policy. Indeed, to the extent that there is a consensus, it perhaps revolves around the path-dependent and contingent nature of social insurance provision, and it is the differences among welfare states as much as their similarity that has attracted a good deal of academic attention.

The limited explanatory power associated with each broad theoretical perspective becomes clear as soon as they are applied to specific country case studies. The democracy variable, for example, is problematic in that many welfare states reached their heyday under communist or autocratic regimes. And in Western Europe it may be argued that it was not so much the advance of democracy as the threat of socialism and communism that launched the welfare state in Bismarck's Germany and fostered its later refinement and growth in the post–World War I and World War II environments (Kapstein 1999).

If disagreements persist about the precise causal variables that have shaped the welfare state, there are also differing views over the typology of such states. Esping-Andersen (1990), for example, has spoken of three welfare state regimes: liberal (Anglo-Saxon), corporatist (continental European), and social democratic (Scandinavian). None of these, however, encompass what might be termed "total" welfare regimes (as were the communist states), or the paternalistic models associated with many autocracies. Further, some scholars and public officials have suggested that there may be a particularly Asian approach to the welfare state, with its negative view of open-ended cash transfers and an emphasis on kinship networks (Birdsall and Haggard 2000). In addition, the social safety net in the Middle East also has its distinctive features, focusing on direct subsidies and universal provision of health and education (Tzanatos and Kaur 2002). Esping-Andersen's classification is thus, at best, only fragmentary, and at worst, Euro-centric and parochial.

Why have societies adopted such differing approaches to social policy? Esping-Andersen focuses on three factors: "the nature of class mobilization (especially of the working class); class-political coalition structures; and the historical legacy of regime institutionalization." Operationalizing these factors, however, presents serious problems for researchers, especially for those who seek to engage in econometric testing of propositions. The absolute size of unions, for example, may mask their much greater political power (that is likely the case for such countries as France), while voting patterns of the middle class vary over time and across countries. In short, finding proxy measures that could yield statistically significant results remains a challenge for welfare state scholars, and that problem is, of course, greatly magnified when one deals with the developing world.

The approach we adopt here is that social policy implementation largely represents a political response by governments as they attempt to win support for their project of economic reform. The possibility of a backlash against market liberalization and globalization suggests the need to bargain with and find payoffs for those most directly affected by economic and technological change. In the absence of such compensation, these groups will have incentives to lobby against and possibly stop the liberalization policies that are being advanced.

Yet the governments of emerging market economies that find it necessary to invest in social safety nets are also confronted by its costs. At a time of severe fiscal restraint, establishing such programs may imply sharp trade-offs with other projects that also have as their objective the buying off of politically important groups; for example, a trade-off between increases in defense and social spending might have to be made. Balancing interests, of course, is the stuff of politics, and there is no reason why social policy should be exempted from that process. But this emphasis on politics indicates why it is that groups without much in the way of political voice—notably the poor—have failed to enjoy much material benefit from the renewed attention being given to social policy around the world.

THE SOCIAL SECTOR IN EMERGING MARKET ECONOMIES

As with the industrial economies, emerging market economies are characterized by great diversity when it comes to the provision of social transfers (see Table 1.2). In addition to the *formal* (that is, government)

Table 1.2 Social Insurance and Social Assistance Cash Spending as Percentage of GDP in Selected Emerging Market and Developed Economies

Country	1985	1988	1990	1995	1997–98
Argentina	5.8	4.4	4.8	8.5	7.7
Brazil	5.9	6.3	8.8	10.3	11.0
Chile	11.8	7.6	7.2	6.8	7.6
Malaysia	1.0	1.1	1.1	1.4	1.0
South Korea	1.0	1.1	1.5	1.5	2.0
Thailand	0.6	0.6	0.5	0.6	0.8
Poland	8.6	8.8	11.0	20.5	19.5
Hungary	12.5	15.1	14.9	16.7	13.2
United Kingdom	12.4	12.4	12.0	15.0	13.3
Germany	13.1	12.6	12.3	16.9	17.0
United States	6.9	6.1	5.8	6.3	5.7

SOURCE: Calculated from IMF, *Government Financial Statistics Yearbook*, various issues, and World Bank DECPO (B. Milanovic) database.

provision of social insurance and assistance shown in the table, there are also *informal* transfers provided by households or extended kinship networks.

The real issue at stake with respect to emerging market economies concerns not so much the existence of social schemes as their effective coverage. With most of the formal programs, coverage is often limited to civil servants or employees of large enterprises and does not reach the lowest income groups. These privileged individuals are "provided with pension schemes, health insurance, and sometimes even unemployment benefits. However, most of the population remains excluded from these schemes" (Decron 1999, p. 1).

An analysis of the demography of formal social provision is suggestive of domestic politics rather than of the economic situation facing the most vulnerable citizens; if social policy is targeted in many countries, it is toward the middle and upper classes. As Carol Graham has written, "[f]ew governments have immediate political incentives for helping the economically poor, who also tend to be poor with respect to political voice" (Graham 1994, p. 8). Further, she and others have also pointed out that economic shocks (like a financial crisis) may not, at least over the short run, have much of a material effect on those in the lowest income deciles (generally the rural poor) as compared to other groups (e.g., industrial workers who lack unemployment insurance), and that these better-organized workers may win from the government and international institutions social policies, like income transfers, that become part of postcrisis adjustment packages.

One of the distinguishing features of most emerging market economies is the heavy reliance that individuals place on informal insurance mechanisms. This informal insurance, provided at the family and community levels, includes "reciprocal need-based gift exchange, trading physical assets, and the use of risk-reducing production techniques" (Morduch 1998, p. 1). Such insurance can be relatively sophisticated, and some forms of it may be in place before crises arise, while others are worked out in the context of particular contingencies. Indeed, owing to the extent and diversity of informal schemes, some observers (Kwon 1997) have asserted that the implementation of government-sponsored social policies will inevitably lead to the disruption—if not displacement—of these fairly dependable grassroots approaches, with a number of unpleasant consequences, including the diminution of community and kinship networks and the extension of (often corrupt) state power.

Yet, as Morduch (1998, p. 8) has argued in a useful overview of the literature, "the optimism" surrounding that view of informal safety nets "has now been tempered." Empirical studies, undertaken in sub-Saharan Africa and elsewhere (including Southeast Asia following the financial crisis of 1997–1998; see Lee 1998), suggest that the coverage provided by these informal networks to the poor is less extensive and less effective than previously believed. Informal insurance may be costly to acquire; it appears "to be particularly fragile when needed most"; and it is "weak against repeated shocks" (Morduch 1998, p. 10). Further, these informal approaches may favor certain ethnic groups, and they assist men to a greater degree than they do women (World Bank 2001, p. 145).

For these reasons, properly designed government programs, which limit the "crowding-out" of private or kinship insurance, have a useful role to play in social insurance and emergency assistance. Public agencies and policies, for example, can help to bolster credit markets, as is the case with student loan guarantees in the United States. The government-provided guarantee does not displace local financial institutions, and it contributes to better economic performance by assisting able students to attain the level of education they seek. This is the sort of policy initiative that arguably contributes to economic efficiency while strengthening family-based support structures.

As Table 1.2 reveals, government spending on social safety nets varies enormously across the emerging market economies. In Asian countries, the amounts are small and although there were some increases in the wake of the crisis, spending there is still far below the levels in Latin America and Eastern Europe. By the end of the 1990s, the southern cone countries in Latin America (Argentina, Brazil, and Chile) were spending between 8 and 11 percent of GDP on social transfers, Poland and Hungary 20 and 13 percent, respectively, and Asian countries only between 1 and 2 percent of GDP. Compare that with West European spending that often exceeds 15 percent and sometimes reaches 20 percent of GDP. Although it is difficult to speak of a trend, because of both the noise in the data and a small sample of countries shown here, on balance, the spending as a share of GDP seems to be increasing. Economic reform, democratization, and demographic change might have been the key drivers behind that development

The extent and effective coverage of social programs remains modest in most developing countries. Cash transfers often amount to no more than a pittance and sometimes go unpaid for long periods of time, as has been the case in Russia. Of course, cash transfers are not the only social programs. If social safety nets in emerging markets can be thought of as “those instruments aimed at mitigating possible adverse effects of reform measures,” it can be seen that many different schemes may be included, including food subsidies, health insurance, public works projects, and educational grants (Chu and Gupta 1998, p. 7). The specific forms of insurance often differ among countries and regions; the former Communist countries still provide a wide spectrum of social programs (if not very effectively), while African countries have extremely limited formal support systems, most of which are targeted at state-sphere workers. Latin American countries often have well-developed pension systems, especially for those in the formal economy, but the effectiveness of that system has diminished in the face of that region’s frequent financial shocks. Public pension schemes, for example, are extremely fragile in a large number of countries and have been a major focus of reform efforts, with Chile leading the way. Yet, the experience with the private pension funds has been much less satisfactory than was originally expected (see Mesa-Lago 2002).

But the articulation and reform of government-sponsored social programs faces a number of political and economic challenges. From an economic perspective, “comparative cost data and cost–benefit analyses are generally not available to help policymakers choose from different types of risk management interventions” (World Bank 2001, p. 146). From a political standpoint, most public officials in emerging market economies probably would not view the use of government authority to extract tax revenues from those in the upper-income quantiles on behalf of those in the lower income quantiles as a winning political strategy.

These facts are suggestive of the political economy issues associated with social policy design and implementation. In seeking to expand the formal safety net in developing countries, governments and international institutions should, as a normative rule, reach out to individuals in the lower-income groups. This requires that the poor be better “targeted” as program recipients. But as Kanbur (1998) has pointed out, targeting brings with it three associated problems, each of which poses difficult problems for even the best-intentioned public officials.

First, for many cash or in-kind transfers, targeting implies that benefits will be removed when and if the recipient reaches a given income level. That means that the recipient faces a potential disincentive for acquiring greater income and “the trade off between incentive and targeting effects will have to be managed” (Kanbur 1998, p. 23). In other words, since he faces a 100 percent marginal tax on his income, he may fall prey to what is called a “poverty trap” and then, in the longer run, to welfare dependency.

Second, targeting may require a substantial addition in administrative capacity and thus in program costs. To the extent that scarce funds become devoted to program managers as opposed to recipients, social policies in effect become jobs programs for the middle class (and international civil servants!). Arguably this has been the case in European welfare states.

Finally, in Gelbach and Pritchett’s (1997) pithy phrase, it may be the case that “more for the poor is less for the poor.” This is because the upper-income quantiles can be expected to balk at paying for programs that do not deliver any benefits to them and refuse to endorse such measures. For this reason of political economy, universal programs may in fact provide more benefits to the poor than those that are explicitly targeted.

Some of these problems may be overcome by the use of self-targeting mechanisms, as in workfare programs where workers are provided low-paying jobs, or by subsidizing specific, often inferior, products which are normally consumed by the poor. The latter is the idea that lies behind the subsidization of staple products (bread, rice, cooking oil), which is commonly done in the Middle East, central Asia, North Africa, and a number of African countries. Despite a rather paternalistic element present in such programs, they have often been very popular with the poor, and despite assurances by the international financial organizations that the leakages are large, and that the programs' removal or "rationalization" would not too adversely affect the poor, the reality has often been different. Removal of subsidies has led to violent reactions and riots, from Algeria to Zambia.

Given these domestic administrative and political economy difficulties, it is not surprising to find external assistance playing such a large role in the funding and reform of social safety net programs in the developing world. According to a study prepared by the United Nations (referred to in Vivian 1994), bilateral and multilateral aid programs in Africa and Latin America have borne a large share of domestic social sector costs. The World Bank, the IMF, the European Union, and other donors have also contributed significantly in both financial and intellectual terms to social policy reform in the post communist transition economies. Further, some safety net programs have, it appears, been *imposed* by international agencies as conditions for receiving assistance during emergencies. While there may be legitimate reasons for international donors to advocate the creation of social assistance and insurance schemes that target the poor, Jessica Vivian has rightly argued that "External funding for safety net programs raises questions of autonomy and sustainability" (Vivian 1994, p. 12), particularly so since that assistance comes in the form of loans that need to be repaid. As of this writing (July 2002), the World Bank is about to disburse some $100 million to Argentina for critical social emergency programs. Yet that money, while highly needed now, will have to be repaid in five or seven years.

We should be cautious, however, not to exaggerate the role of the international financial institutions or bilateral aid agencies; most countries, even in the developing world, depend mainly on domestic budgetary resources for carrying out their policies. Nor should we imagine that social development is a disaster everywhere. As Dharam Ghai has pointed out, there are several important cases in which countries have managed "to reach a level of social development distinctly superior to that which would be expected on the basis of their level of per capita income." (Ghai 2000, p. 1). How countries such as Chile, Costa Rica, and Sri Lanka, or regions within countries, such as the Indian state of Kerala, have achieved that level of performance is a puzzle that needs some explanation, and drawing appropriate lessons from these experiences should be high on the international policy agenda.

According to Ghai, three factors "have been crucial" to policy success, and it is useful to evoke them here:

> First, all these countries were characterized by a political leadership that was strongly committed to the provision of health and educational services to the entire population. Second, in all cases the state played a central role in extending a minimum core of services throughout the country. Thus the administrative capacity of the state and the infrastructure necessary to reach all parts of the country and the major segments of the population were vital to their success. Thirdly, the composition of public social expenditure—emphasizing literacy, basic education, and primary health care—rather than its relative size, accounts for their social achievements. (Ghai 2000, p. 3)

What these points suggest is that universal social programs, like spending on health care and education, are more likely to win the support of elites in the upper-income brackets than are targeted programs that emphasize cash transfers and subsidies. Indeed, this point was made by Clive Bell as early as 1974, in his contribution to the seminal work *Redistribution with Growth* (see Chenery 1974, pp. 53–72). Bell wrote that "certain kinds of investments in the poor, such as education and health, may lead to long term pay-offs to the rich, who need productive workers to operate their capital" (Bell 1974, p. 54).

But even with respect to education, the political economy dynamics present a troubling aspect in most of the emerging market countries. While the rich may support universal basic education, access by the poor to secondary and tertiary schooling is much more limited. Across the developing world as a whole, the poorest fifth of the population receives only 3 percent of public expenditure on tertiary education, while the richest fifth receives almost 70 percent. In short, a disproportionate share of spending on higher education goes to those in the upper-income deciles, limiting education's power as a vehicle for social mobility (Landa and Kapstein 2001, p. 142).

WHAT ARE THE OPTIONS?

We have characterized the emerging market economies as having an increasing demand for social policies but an unsatisfactory supply due to limited administrative capacity, fiscal constraints, and impediments posed by political economy considerations. These problems necessarily limit the extent and effectiveness of government-sponsored social schemes. Although growing, bilateral and multilateral transfers in support of social insurance still represent only a small share of GNP for most countries. At the same time, family and kinship networks, which need strengthening to cope with severe shocks, as occurred during the Latin American debt crisis or the Asian financial crisis, may in fact be threatened by efforts to increase the state's reach in this domain. Thus, the one system that actually works, even if only partially and most imperfectly, could be imperiled by the well-meaning efforts now on the global policy agenda.

That portrays a grim picture. But it does suggest that one ought to proceed cautiously with social policy implementation and reform. What are the policies now under consideration? Among those policies, which are most likely to prove useful to those who have greatest need for social services? We discuss these questions in the remaining chapters.

Note

1. In this book we define social policy in terms of social assistance and social insurance programs, focusing on unemployment insurance, pension schemes, and other income transfers. While we also discuss spending on education and health, and believe that public policies in these areas are critical to the life prospects of those in the lower-income quantiles, these topics merit and have received separate treatment elsewhere; see, for example, United Nations Development Program (1999).

2
Openness and Changes in Income Distribution

During the past decade, many countries have engaged in economic liberalization programs of one kind or another. Common to most of these programs is a commitment to greater openness to flows of trade, finance, and direct investment. Indeed, openness—or globalization—is perhaps the single economic reform that has been adopted with greatest enthusiasm by policymakers.

That development is not without its puzzles, at least from the perspective of modern political economy. Classic theories of political economy hypothesize that concentrated protectionist groups will have greater influence over policy making than the diffuse consumer groups that are in principle the main beneficiaries from globalization. Overcoming domestic resistance to trade opening, therefore, would seem to be one of the major challenges facing would-be reformers.

Empirically, alongside the rise in openness, economists have also observed a near-global trend toward increases in income inequality. In both industrial and developing countries, there appears to be an emerging pattern of "winners" and "losers" that is only partly consistent with the expectations of received trade theory. Explaining the causal factors behind the increase in inequality has sparked a major research program in modern economics.

To date, most of this research and debate has concentrated on the effects of globalization on inequality *within* industrial countries. In other words, the discussion has been mainly about how globalization has affected wage and income inequality in the United States or Western Europe (e.g., Slaughter and Swagel 1997; Dluhosch 1998; Schott 1999; Lejour and Tang 1999). A second strand of research, however, has concentrated on how globalization might affect the distribution of GDP per capita *between countries*, by leading to differences in mean per capita growth rates.

Neither of these two approaches has taken a sustained look at how globalization affects the within-country income distribution among the less developed economies. Some work has sought to analyze the effects of globalization on growth within less developed countries focusing on the effects of technology transfer (Gundlach and Nunnenkamp 1996), and theoretical models of income distribution have also been developed (e.g., Wood 1995; Benarroch and Gaisford 1997). Empirical studies of income distribution, in contrast, are few (but for some important exceptions see Harrison and Hanson [1999] and Robertson [2000], who study wage inequality in the wake of Mexican trade reforms; Beyer, Rojas, and Vergara [1999], who look at inequality in China; and Arbache [1999], who studies the effect of market liberalization on intersectoral wage dispersion in Brazil).

The objective of this chapter is to put some "empirical meat" on how globalization affects income distribution in both less developed and advanced countries. We do this using a newly developed database. The advantages of the new database are twofold: first, it is entirely based on national household surveys around two benchmark years (1988 and 1993), so that income inequality statistics are almost fully mutually comparable; second, it gives not just one or two income inequality measures (say, Gini coefficients or Theil indices), but the actual data on income levels across 10 deciles of income distribution. This ability to look at what is happening along the entire income distribution rather than looking at one summary statistic, like the Gini, is crucial if we want to get a better grasp on how globalization affects the distribution.

The chapter thus has two aims: first, to document changes in the variables thought to reflect globalization over the last 15 years, and second, to try to link them to the changes in income distribution. These changes are critical, we argue, to social policy reform. Recalling the argument developed in Chapter 1, we assert that while globalization has produced new winners in developing countries, it also has increased the risks to their income streams, raising the demand for social insurance programs, notably unemployment compensation and pensions. These two programs—as opposed to, say, poverty relief—have arguably been the centerpiece of contemporary efforts at social policy reform. We therefore seek to link changes in the global economy with changes in domestic policy.

WHAT DOES IT MEAN TO BE GLOBALIZED?

Globalization means many things to many people, and as such the term often produces more confusion than analytical clarity. It is therefore useful to begin our chapter with an official definition. The World Bank defines globalization as the "Freedom and ability of individuals and firms to initiate voluntary economic transactions with residents of other countries" (World Bank 2002). Empirically, globalization translates into greater mobility of the factors of production (capital and labor) and greater world integration through increased trade and foreign investments—both direct and portfolio. Several recent papers that compare two globalization waves—the first at the end of the 19th century up to 1914, and the current wave beginning around 1970—look precisely at these indicators—how much trade there is now (as the share of world GDP) compared to a century ago, how much direct foreign and portfolio investment, and how easy is it for people to move or to settle in different countries (see Bordo, Eichengreen, and Irwin 1999; Williamson 1996; Craft 2000; and Baldwin and Martin 1999).

The studies come up with a mixed verdict on the extent of past versus current globalization. Trade as a share of world GDP is about the same now as then, while portfolio investment and the ability to travel are greater today; in contrast, the ability to resettle elsewhere is less.

Less-developed countries are affected by globalization principally in two ways. First, they are able to export more of their own goods (and to import more), and they can be expected to be recipients of direct foreign and portfolio investments from the capital-rich countries. According to the simple version of the Hekschler-Ohlin-Samuelson (HOS) model, less-developed countries will tend to export low-skill intensive products, because low-skilled labor is their abundant factor of production and its price will therefore be low. Similarly and for the same reason, foreign investors will also tend to invest in low-skill intensive processes. Moreover, as the more advanced countries have an advantage in skill-intensive products and tend to export these, there also should be a reduction in relative wages of highly skilled workers in less-developed countries. When we translate this into the implications for income distribution, and approximate the latter by the ratio between the high-skill and low-skill wage, it appears that income inequality *within* the less-developed countries should go down. Mirroring these developments, income distribution in more developed countries should become more unequal. This is directly derived from Samuelson's price-equalization theorem in its most abstract formulation (see Freeman 1995 and Wood 1994, 1995).

As less-developed countries continue their process of modernization, which implies improvements in educational attainment, the relative supply of high-skilled people increases compared to the low-skilled people (although not to the extent that it would reverse the comparative advantage of the country). This seems to further reduce the wage differences between the high- and low-skilled workers and to shrink wage (and thus income) distribution. Relative demand shifts occasioned by globalization would tend to favor less-skilled workers, and so do relative supply shifts brought about by better educational achievement.

What may be the offsetting elements? There are at least two. First, rather than looking at globalization through HOS lenses, we may look at it as a Kuznets-type process. Suppose that instead of two types of labor (low- and high-skilled) we have three types of labor (low-, medium-, and high-skilled). Globalization may produce movement of labor from the low-wage, predominantly agricultural sectors, where wage differentiation is minimal, to medium-skill sectors in urban areas, where wage differences are larger. Then, even if the ratio between the top and bottom shrinks (as the ratio between high-skill and low-skill wage becomes smaller), overall wage and income inequality might increase simply because of the greater wage differentiation in the middle. In conclusion, the ratio between the average wages for different types of labor is not sufficient to describe what happens to the distribution. We need to look at the pattern of change across the entire distribution.

Second, although wages are usually the largest chunk of total income, there are two other sources that affect income inequality significantly: self-employment income (including home-consumption) and capital (property) income. The share of self-employment income would tend to go down as people move from basically subsistence agriculture (this assumes that peasants are mostly landowners) to become wage-workers. The importance of capital income will depend on what happens to the real interest rate, whose level is, in turn, dictated by what happens in rich countries; this is particularly so in an era of globalization. Since property income is very strongly concentrated among the top income classes, that element too might provide a very strong countervailing force to decreasing inequality—much greater in effect than a simple share of capital income in total would imply.

MODELING THE CHANNELS OF INFLUENCE

In a very simple way, the absolute income level of the *i*th decile in the *j*th country at time *t* can be written as a function of an inequality parameter specific to the country (I_{jt}) and the mean income of the country (m_{jt}), both, of course, subscripted for time.

(1) $y_{ijt} = f(I_{jt}, m_{jt})$

The relative income of the *i*th decile (normalized by the mean) is then

(2) $\dfrac{y_{ij}}{m_{jt}} = g(I_{jt}).$

The change in *i*th decile relative income between the two time periods becomes

(3) $\Delta\left(\dfrac{y_{ij}}{m_j}\right) = h(\Delta I_j).$

We now allow for two possibilities that will represent the two ways in which we test our hypothesis of the effect of the globalization variables on income distribution. First, we assume that the level of our inequality index depends on the levels of the variables listed below, and second, that the change in the inequality index between the two time periods depends on the change in the same variables:

1) two “standard” globalization variables, namely openness (OPEN_j), measured as the sum of exports and imports in country’s GDP, and direct foreign investment as share of GDP (DFI_j);

2) financial depth (FD_j), the ratio of M2-to-GDP, introduced on the assumption that greater financial depth should reduce the importance of financial constraint to borrow for education purposes, and thus should help those who are talented but lack resources (see, for example, Li, Squire, and Zhou 1998); and

3) an indicator of democracy (DEM_j), on the assumption that democratization, through the median voter hypothesis, should

lead to a reduction in inequality (see Gradstein, Milanovic, and Ying 2001; Landa and Kapstein 2001).

In our model, financial depth and democracy are not directly linked with globalization, even though one might plausibly entertain such a view. For example, one can regard increasing financial depth, that is increasing monetization of the economy, to proceed directly from better integration of a country into the international economy, and democratization to occur in response to greater international exchange and global political trends, like the end of the Cold War. However, in seeking a direct test for the impact of openness on income distribution, we view these two variables as controls and introduce them primarily to avoid misspecification of our model. We then rewrite equations (2) and (3) (omitting t for simplicity) in the reduced form as

$$\text{(2a)} \quad \frac{y_{ij}}{m_j} = \Psi(\text{OPEN}_j, \text{DFI}_j, \text{FD}_j, \text{DEM}_j)$$

$$\text{(3a)} \quad \Delta\left(\frac{y_{ij}}{m_j}\right) = \psi(\Delta\text{OPEN}_j, \Delta\text{DFI}_j, \Delta\text{FD}_j, \Delta\text{DEM}_j),$$

where Δ, of course, represent changes between the two time periods, y_{ij} = income of ith decile (deciles go from the poorest, 1, to the richest, 10), jth country; ΔOPEN = change in openness between 1985–1991 and 1992–1997; ΔDFI = change in direct foreign investment as share of GDP over the same two periods, ΔFD = change in financial depth (M2/GDP), and ΔDEM = change in democracy over the same two periods. Of course, 10 regressions such as (2a) and (3a) are estimated—one for each decile.

However, we also need to take into account the fact that the globalization variables will not affect the share of a given decile the same regardless of the country and its level of development. Consider the following fact: increased openness and direct foreign investments will, as the economic theory tells us, tend to benefit low-skilled workers in poor countries because low-skill intensive industries would be both attractive to foreign investors and likely to take advantage of export opportunities. Thus, we would expect that the sign of OPEN and DFI variables will be positive among the bottom deciles in poor countries. But for a rich country, the situation is exactly the reverse. Openness will mean that it is the low-skilled workers in rich countries that would be exposed to increased foreign competition (see Wood 1995); such low-skill intensive products are unlikely to be exported by the rich countries, and we would expect that sign of OPEN and DFI variables to be negative for low deciles in a rich country setting. The coefficients of two globalization variables will therefore vary as a function of the income level of the country. Ideally, of course, the coefficients should vary as a function of the skill composition of each income decile and country's income level. However, since we do not have information on who exactly is in each decile and what is the skill composition of people per decile, we shall have to use the country's income level as a sole determinant.

Thus, we can write for each decile:

$$\text{(2b)} \quad \frac{y_{ij}}{m_j} = \beta_{0i} + \beta_{1i}\,\text{OPEN}_j + \beta_{2i}(\text{OPEN} \times m_j) + \beta_{3i}\,\text{DFI}_j + \beta_{4i}(\text{DFI} \times m_j) + \beta_{5i}\,\text{FD}_j + \beta_{6i}\,\text{DEM}_j + e_{ij}$$

$$\text{(3b)} \quad \Delta\left(\frac{y_{ij}}{m_j}\right) = \beta_{1i}\Delta\text{OPEN}_j + \beta_{2i}(\Delta\text{OPEN} \times m_j) + \beta_{3i}\Delta\text{DFI}_j + \beta_{4i}(\Delta\text{DFI}_j \times m_j) + \beta_{5i}\Delta\text{FD}_j + \beta_{6i}\Delta\text{DEM}_j + u_{ij},$$

where the error terms e_{ij} and u_{ij} are assumed to have the usual desirable properties. As for the signs of β_{5i} and β_{6i} associated with financial depth and democracy, respectively, we expect them to be positive among the low deciles and negative among the higher income deciles. This is based on the theory that lack of deep financial markets (the inability to borrow against one's future income) is bad for the poor and for equality (see Li, Squire, and Zhao 1997), and that democratization should likewise help the poor by leading to greater redistribution (see Gradstein, Milanovic, and Ying 2001).

GLOBALIZATION-RELATED VARIABLES: SOME RECENT FACTS

Before trying to link globalization and other macro variables to changes in income distribution, we need to define our variables more precisely. For the distribution, we use the data on incomes expressed in international dollars of equal purchasing power ($PPP) of each decile for almost 90 countries around 1988 (more exactly, between 1985 and 1991) and around 1993 (more exactly, between 1992 and 1997). All right-hand side variables are calculated as the averages over a period. There are two reasons for doing this rather than simply using a single value for 1988 or 1993. First, the distribution data are only "benchmarked" in 1988 and 1993, yet the actual surveys that we use to derive the decile data might have been conducted in the years around 1988 (say, 1986 or 1989). The situation is the same for the year 1993. (For the list of surveys, source of data, etc., see Milanovic 2002, Appendix 1.) Second, even if all surveys were conducted in the same year, there would be some advantage in relating mean decile incomes to, say, several years' average share of exports and imports in GDP, in order to avoid having the results be swamped by very short-run changes. As mentioned before, globalization is reflected in two variables: openness—share of combined exports and imports in GDP—and the share of direct foreign investments in GDP of the recipient country. Openness that is associated with income distribution circa 1988 is taken to be the average of exports and imports over GDP during the period 1985–1991 (*openpre*). Openness that is associated with income distribution in 1993 is defined as the average over 1992–1997 period (*openpost*). The change in openness is then obtained as *openpost-openpre*. Identical calculations are done for direct foreign investment, M2/GDP, and democracy variables.

Table 2.1 shows mean-normalized average incomes of each decile in 1988 and 1993. For example, we see that on average (calculated across 88 countries and without any weighting) in 1988, the bottom decile's income was 30.7 percent of the mean. By 1993, the bottom decile's income was only 24.8 percent of the mean. Relative incomes of the bottom seven deciles went down, with the negative change the largest among the poor deciles, while the relative income of the top three deciles went up, again with the greatest positive change among the top. Thus, for example, on average, people in the top deciles in 1988 were having incomes that were 2.735 times greater than the national mean. In 1993, their incomes were almost three times greater than the mean. So, on a cross-country basis, we seem to have had an increased inequality: incomes of the low deciles have tended to fall behind the mean income growth, while incomes of the top forged ahead of the mean.

Table 2.1 Mean-Normalized Average Incomes of Each Decile (across countries; not weighted for population)

Income decile	1988	1993	Change
First	0.307	0.248	–0.059
Second	0.443	0.399	–0.044
Third	0.541	0.503	–0.039
Fourth	0.637	0.600	–0.037
Fifth	0.738	0.707	–0.031
Sixth	0.857	0.836	–0.021
Seventh	1.003	0.988	–0.014
Eighth	1.201	1.208	0.008
Ninth	1.538	1.577	0.039
Tenth	2.735	2.934	0.198
Total	1	1	0

NOTE: Based on 88 same countries in 1988 and 1993. Deciles formed based on per capita income or expenditures (obtained from household surveys).
SOURCE: Authors' calculations.

Table 2.2 shows the increase in the combined share of exports and imports in GDP over the 1985–1998 period. There is a sustained increase in the (unweighted) share from around 60 percent in the mid 1980s to almost 80 percent in the late 1990s.

Even more dramatic were increases in foreign direct investment as a percentage of GDP for the recipient countries (Table 2.3). The unweighted importance of foreign direct investments increased from about 1.1 percent of GDP in 1985 to 5.6 percent in 1998. If we compare the first (1985–1991) and the second (1992–1997) periods, for 52 countries the average share of DFI inflows in GDP increased, while for only 10 countries it became less important. In 7 countries (Lesotho, Luxembourg, Panama, China, Bolivia, Hong Kong, and Peru) the share of direct foreign investment in GDP in the second period exceeded by more than 5 GDP percentage points share in the first period. The most important increases were registered in Lesotho (from 2.7 to 24 percent of GDP) and Luxembourg (from 66 to 81 percent of GDP). For China, the importance of DFI went up over the same period from an average of less than 1 percent of GDP to more than 5 percent of GDP. In the United

Table 2.2 Share of Exports and Imports in GDP (across countries; not weighted for population)

Year	Number of countries	Average share of openness (%)	Minimum (%)	Maximum (%)
1985	69	62.3	14 (India)	209 (Hong Kong)
1986	70	59.9	14	214
1987	71	60.7	14	235
1988	71	62.2	15	257
1989	71	64.9	14	255
1990	71	65.8	14	260
1991	72	65.5	14	271
1992	79	64.1	15	281
1993	84	66.8	16	274
1994	86	70.6	17	278
1995	87	74.8	16	303
1996	86	74.4	16 (Brazil)	286 (Hong Kong)
1997	85	77.0	18 (Brazil)	264 (Cyprus)
1998	63	79.2	18 (Brazil)	250 (Hong Kong)

SOURCE: Calculated from *World Development Indicators,* World Bank. SIMA Database, World Bank.

States, DFIs increased from 0.9 to 1 percent of GDP. India, which started with almost no direct foreign investments, reached one-half of one percent of GDP in the second period.

We are less interested in the other two control variables, financial depth (M2/GDP) and democracy. The former is measured in a straightforward fashion, as the ratio of M2 to GDP. The latter is measured by the Executive, or Legislative, Index of Electoral Competitiveness, the two variables from the Database of Political Institutions (DBI) developed by Beck et al. (2000). Indexes' values range from 1—least democratic—to 7—most democratic.

Income distribution and globalization: the empirics

Next we estimate the two types (level and change) of regressions shown in equations (2b) and (3b). There are 10 such cross-sectional

Table 2.3 Gross Foreign Direct Investment as Percentage of Recipient Countries' GDP (unweighted average)

Year	Number of countries	Percentage of GDP
1985	66	1.09
1988	67	1.90
1989	67	2.63
1990	69	2.42
1991	71	2.35
1992	82	2.27
1993	85	2.55
1994	86	3.08
1995	87	3.16
1996	87	3.48
1997	87	4.33
1998	86	5.63

SOURCE: Calculated from *UNCTAD Handbook of International Trade and Development Statistics*, 1996, 1997, 2000.

regressions under each specification: one for each income decile, run across all countries. But since income shares are determined simultaneously, we need to run the decile regressions as a simultaneous system (leaving aside one decile in order to avoid orthogonality). We thus avoid the inconsistency of having a possibility of a right-hand side variable affecting all *shares* negatively or positively. The results are shown in Table 2.4.[1]

As can be seen in Table 2.4, for the bottom seven income deciles, openness is negatively related to their mean-normalized income (or put differently, their income share). However, that negative effect is lessened for richer countries as the interaction term between openness and mean income is positive. Openness would therefore seem to have a particularly negative impact on the poor and the middle-income groups in poor countries—which is directly opposite to what we would have expected based on theory. It is only when income level leaches $5,000–$6,000 in purchasing power terms (that is, around the income level of the Czech Republic, Colombia, or Chile), that for the poor (the bottom three deciles), openness becomes a "good thing"—it raises their share in total income. For the middle deciles, the turning point occurs earlier,

Table 2.4 Explaining Mean-Normalized Decile Incomes (1988, 1993) (regressions estimated simultaneously; dependent variable: decile income/mean income)

	First	Second	Third	Fourth	Sixth	Seventh	Eighth	Ninth	Tenth
Openness	–0.099*	–0.172**	–0.189**	–0.180**	–0.144**	–0.107**	–0.023	0.117*	0.960**
	(0.015)	(0.000)	(0.000)	(0.000)	(0.000)	(0.003)	(0.486)	(0.040)	(0.000)
Interaction of openness and mean income	0.00002**	0.00003**	0.00003**	0.00003**	0.00003**	0.00002**	0.00001**	–0.00002**	–0.0002**
	(0.001)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.010)	(0.007)	(0.000)
DFI	–0.515	–0.390	–0.385	–0.553	–0.579	–0.482	–0.131	0.368	3.242
	(0.311)	(0.489)	(0.492)	(0.323)	(0.228)	(0.277)	(0.754)	(0.606)	(0.325)
Interaction of DFI and mean income	0.00003	0.00001	0.00001	0.00002	0.00002	0.00002	–0.000002	–0.00002	–0.0001
	(0.364)	(0.762)	(0.795)	(0.566)	(0.493)	(0.565)	(0.947)	(0.726)	(0.593)
Financial depth	0.003	0.003	0.002	0.002	0.003	0.002	0.002	0.0002	–0.019
	(0.422)	(0.477)	(0.544)	(0.591)	(0.378)	(0.454)	(0.527)	(0.963)	(0.393)
Democracy (0EIEC)	–0.022**	–0.021**	–0.020**	–0.019**	–0.015*	–0.014*	–0.011*	0.004	0.135**
	(0.000)	(0.003)	(0.005)	(0.008)	(0.011)	(0.014)	(0.039)	(0.658)	(0.001)
Constant	0.376**	0.527**	0.630**	0.725**	0.928**	1.067**	1.253**	1.544**	2.131**
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
No. of observations	113	113	113	113	113	113	113	113	113
Pseudo R^2	0.195	0.285	0.314	0.309	0.321	0.261	0.090	0.106	0.303

NOTE: * Statistically significant at the 5% level; ** statistically significant at the 10% level. Values in parentheses give the level of significance at which the null hypothesis is rejected.

around \$PPP 4–5,000. At about the same income level, the rich (top two deciles) who initially benefited from openness begin to lose (in relative terms). Thus, openness raises the relative income of the rich in poor countries, but its positive effect on the rich is reduced as mean income of the country goes up.

The results of the level regression thus suggest an almost Kuznets-like effect of openness on income distribution. When a country is relatively poor, increased openness raises the income share of the top and reduces the income share of the poor groups as well as of the middle class. (We are throughout talking of “shares,” not absolute incomes.) However, at some medium level of income (\$PPP5,000–\$PPP6,000 per capita based on household survey data), the income shares of the poor and the middle class begin to be positively affected by openness while the income share of the rich begins to decline. Finally, for the rich countries, openness is associated with increasing share of the bottom and middle deciles, and decreasing share of the top deciles. In sum, at low-income levels openness is bad for equality; at medium- and high-income levels it promotes equality.

This suggests that only the middle-income countries behave as the rigorous version of theory would imply. But poor countries whose equality should be helped by openness, and the rich countries where openness should increase income differentials, behave in the exactly reverse fashion from what we would expect. However, these results are consistent with those posited by Wood (1994). In his model, poor countries that open up may experience increased inequality because there are three types of labor, and although the openness helps those with basic and high education, it reduces the income share of those with no education (they fall further behind). It is only when basic education becomes the norm—and even the poor have it—that openness exerts an income-equalizing effect. This is what we might be picking up in our results that show a rising income share for the lower and middle classes in middle-income countries following openness. As Wood (1994) argues, an economic strategy based on exports of manufactures that requires at least basic education would be equitable in Korea but inequitable in Burkina Faso or Pakistan.

Direct foreign investments (as a share of a country’s GDP) or financial depth are not significant in any regression. Democracy, proxied by the way that the country’s leader is elected, is shown (surprisingly) to be negatively associated with income share of the poor and the middle class, and positively associated with income share of the top decile. However, when we proxy democracy by the level of democracy in election of legislature (national Parliament), the effect disappears—there is neither a positive nor negative effect (not shown here).

When we look at the effect of the same variables on change in decile shares between 1988 and 1993, the results change. No variable is now shown to be statistically significant. The impact of our variables on changes in shares is apparently much more difficult to detect—possibly because the time period under consideration is short.

What do these findings suggest for social policy? First, if globalization is associated with decline in relative and perhaps absolute income of the poor in poor countries, and since the "losers" thus combine both negative attributes—namely, to have no influence and to live in poor countries—we would expect that no social transfers would flow their way. So, it is the poor in the poor countries who are likely to be worse off as globalization proceeds. Second, to the extent that globalization increases the demand for those with basic education or some skills, it also has the potential to increase their income. In effect, it is precisely the poor and the middle classes in middle-income countries that, according to our results, behave as the theory predicts: they gain in relative terms. But while they gain, openness may be associated with a greater variability in their income streams. That variability gives rise to insecurity, and thus to a demand for more social insurance. As we will see in Chapter 4, it is in two middle-income countries, Chile and South Korea, where demands for social policy reform have been greatest.

Note

1. We allow for possibility that income level may influence relative income shares in equation (2b) and introduce mean household survey income and mean squared income. However, neither variable is significant.

3
Three Crises: Latin America, The Transition, East Asia

One of the ongoing debates in economic development concerns the importance of politics and effective policy making to the growth process. For much of the post-war era, these topics were not prominent in the economics literature, which instead focused mainly on capital accumulation. The diversity of development experiences, from the relatively protected economies of Latin America to the communist regimes in the Soviet bloc to the export-oriented Asian "tigers," suggested that there was no single growth-oriented set of policies that had to be followed by developing countries. Nor did it appear that democracies grew more or less quickly than other types of political organization. For these reasons, economists focused their attention and research on technical variables such as savings, investment, technological change, and demographics.

Over the past two decades, however, a series of crises have shaken not just the global economy but the economics profession as well. These shocks—notably the Latin American debt crisis that began in 1982, the postcommunist transition launched in 1989, and the Asian financial crisis that erupted in 1997—spurred a new approach to development studies. Now the role of domestic and international policy making has risen to the fore, and out of this debate has emerged a general agreement among mainstream academics and international bureaucrats (the so-called "Washington Consensus") (Williamson 1990) about the policies that were needed to encourage sustained growth. These policies included macroeconomic stabilization, market liberalization, and greater openness to flows of trade, finance, and direct investment. Over the ensuing years, the international financial institutions would tie their conditional lending packages to acceptance by governments of these general policy guidelines.

But these policies did not have neutral distributive effects within countries. To the contrary, they seemed to generate new patterns of "winners" and "losers." It is our hypothesis that economic reform unleashed a process of change that threatened the income streams of particular groups of workers, increasing their demand for consumption-smoothing policies. While reform would probably benefit skilled workers over the long run, especially those in middle-income developing countries, it also made them more vulnerable to shocks, including those emanating from the global economy to which they were increasingly exposed. Over time, the need to introduce social policies to buffer the worst effects of the adjustment and reform process would become part of a "second generation" Washington Consensus that now emphasizes the role of politics, policies, and institutions.

Accordingly, we begin this chapter with a brief discussion of the political economy of economic reform. As we shall see, rather than being a tide that lifts all boats, changes in economic policy normally have distributive consequences for different sectors of the economy and factors of production. The potential losers from policy change will seek to veto, reverse, or render ineffective those reforms, or win compensation for any losses they might suffer. Their ability to do so, however, will be a function of their organizational capacity on the one hand, and of the state's budget on the other.

As argued before, it is not necessarily the case that the immediate losers from sudden economic change will be located among the poor and lower classes, but instead may be found among those in higher income groups. These include workers in state-sphere enterprises who are made redundant following restructuring and privatization, and those in protected industries that face the challenge of market opening. We argue in this chapter that it is these groups, rather than the rural poor, who have generally lobbied for social transfers *qua* compensation. Yet the success of aggrieved groups in winning social benefits from the state has varied greatly across countries. Pensioners and the unemployed, for example, fared better in Poland than they did in Russia. These outcomes remind us of the differing capacities of various social groups to gain voice in reforming economies, given the political and economic structures and institutions in which such reforms take place.

STRUCTURAL ADJUSTMENT AND THE POLITICS OF ECONOMIC REFORM

Beginning in the 1970s with the oil crises, a number of severe shocks threatened the stability of the contemporary international economy and caused governments to adjust or reform long-standing monetary, fiscal, and industrial policies. In many developing countries, the impetus for reform often came from the international financial institutions in the form of conditional lending programs, in which currency devaluations and sharp spending cuts, coupled with macroeconomic stabilization and market liberalization, were usually the order of the day. These "structural adjustment" or austerity programs rarely had deep political support, and strikes and riots often followed in their train.

The origins of structural adjustment lending date back to the first oil crisis of 1973–1974, at which time the IMF created the Extended Fund Facility (EFF) to extend credits for longer than usual periods. The IMF "specified that the purpose was to help countries carry out 'comprehensive programs that include policies of the scope and character required to correct structural imbalances in production, trade, and prices.' That focus on 'correction of structural imbalances' then became known informally in the Fund as structural adjustment" (personal communication from IMF historian James Boughton, February 6, 2001).

Two years later, in 1976, the IMF established a trust fund in order to make low-interest loans to poor countries. In 1985, when the IMF was debating how to use the proceeds of repayments of Trust Fund loans, the executive board established a new facility with conditionality similar to the EFF but with concessional terms similar to the Trust Fund. At one board meeting, Charles Dallara, then the U.S. Executive Director, proposed that the goal of the proposed facility should be to "promote structural adjustment and growth." The term was readily embraced by potential borrowing countries, who saw it as an alternative to conventional conditionality that emphasized adjustment of aggregate demand and that often required implementing austerity measures. At a subsequent board meeting in 1985, E. I. M. Mtei, the Executive Director for Tanzania, argued that "what is needed is structural adjustment programs developed within a medium- and long-term framework stressing growth" (personal communication from IMF historian James Boughton, February 6, 2001). In 1986, the IMF staff embodied these ideas in proposing that the new facility be called the Structural Adjustment Facility, or SAF. It should be emphasized that, in parallel with these efforts by the Fund, the World Bank began also to make structural adjustment loans to member countries.

While the content of these programs has varied from one country to the next, there has been a fair degree of intellectual consensus on what constitutes an appropriate economic strategy: "[t]his strategy emphasizes fiscal rectitude, competitive exchange rates, free trade, privatization, undistorted market prices, and limited intervention" (Rodrik 1996, p. 9). The objective of these reforms has been to place countries on the path of sustained growth.

One would expect new economic policies to meet with universal approval only if they made—or were expected to make—everyone better off than they had been under the old system. And in theory, given powerful assumptions about factor mobility, that outcome is feasible over some relevant time horizon. But over the short run, individuals are naturally subject to income gains and losses. The question that reform thus poses is "whose ox gets gored" and the answer will likely depend on existing political and economic structures (see Przeworski 1991, pp. 159–161).

With hindsight, it appears that the advocates of the Washington Consensus were either slow to appreciate the distributive consequences of their policy recommendations or neglectful of them. Only in recent years has the literature on the political economy of economic reform—with its emphasis on the role of interest groups, institutions, elections, and political parties—blossomed. If public officials in emerging market economies have undertaken reforms only hesitantly and selectively, perhaps it is due to the fact that they have had a greater appreciation for the politics associated with these distributive issues than the intellectuals and international bureaucrats who determined the building blocks of "good policy."

"Economic reform is inherently political," writes Robert Adams, "because by changing the distribution of benefits in society . . . (it) benefits some social groups and harms others" (Adams 1998, p. 2). Indeed, why any government would launch reforms in the face of certain opposition provides a theoretical and empirical puzzle that has generated substantial research. Some authors claim that, given the obvious up-front costs associated with policy change, authoritarian regimes, acting in the "national interest," are best suited to launch reform measures. Even in democracies, reform packages "were either pushed through legislatures rapidly or launched by decree" (Nelson 1993, p. 438). Furthermore, some of the most important policies, like currency stabilization, were undertaken by independent central banks that were free from political control. In essence, this body of work assumes that there are clear costs associated with reform that democracies are not well suited to overcome.

Perhaps the most vigorous objection to this perspective has come from political scientist Adam Przeworski. In a careful study of the Polish reform, Przeworski argues that the early reformers, notably Prime Minister Leszek Balcerowicz, would have had greater success (Balcerowicz was defeated in the election of 1993, which brought former communists to power) had they encouraged more democratic debate of the "shock therapy" program on the one hand while providing a strong safety net on the other. Democratic debate, Przeworski claims, would have helped deepen support for the reform process, while safety nets would have compensated the losers, especially in the face of rapidly rising unemployment (Przeworski 1991).

Yet, as Dani Rodrik points out, the claim that "reforms tend to make things worse before they make them better . . . is startlingly lacking in empirical support" (Rodrik 1996, p. 29). It is an assertion in which the counterfactual must be that economic performance would have been better, at least in the short run, had the reforms not been undertaken. Running this experiment, of course, is impossible in the real world, but the evidence we have from countries that have failed to reform (e.g., North Korea and Ukraine) is hardly encouraging. That being said, the distributive consequences of reform should not be minimized. The political question then revolves around the relative capacities of the potential winners and losers to influence the direction of policy change.

In thinking about how adjustment policies may affect the welfare of particular societal groups, let us consider the problem of employment levels in greater detail. After all, reform programs that emphasize the need for austerity will likely bring countries into recession, increasing the number of jobless. And because unemployment will produce the single greatest income shock to workers in the formal sector, workers may be expected to resist such measures.

It is widely assumed in the literature on reform that labor will be the big loser from economic liberalization. But *labor* is a broad term, covering both skilled and unskilled workers. Przeworski, for example, asserts that "unskilled workers are the ones most likely to suffer from the onset of unemployment," and he finds that the interests of organized labor were consistently overlooked in the early years of postcommunist transition, in which rising unemployment was one of the key indicators of the economic reforms (Przeworski 1991, p. 160). Joan Nelson similarly writes that "organized labor often or usually bears a greater share of the costs of adjustment than other factors of production" (Nelson in Haggard and Kaufman 1992, p. 229), and as a result "almost all programs of vigorous liberalization proceed by ignoring or repressing organized labor" (Nelson 1993, p. 439).

Despite this conventional wisdom, it is not immediately obvious that labor is invariably the major loser from structural adjustment. If we examine the two policies that are often central to conditionality packages—fiscal discipline and devaluation—the effects on employment may run in opposite directions. Fiscal rectitude leads to reduced demand and labor retrenchment; devaluation to increased prices of tradables and higher exports of labor-intensive products. *Labor* is also too coarse a term to capture the factor effects, and we need to specify more clearly which labor groups have been particularly hurt by the reform measures. Further, the distributive effects of reform on different groups may change across countries, as we will see in the following chapter.

To be sure, by dampening demand, stabilization measures can reduce "employment growth or even its volume" (Morrison 1992). But at the same time, "labor is likely to benefit from a devaluation that . . . raises the relative price of labor-intensive manufactures vis-à-vis more capital-intensive sectors" (Adams 1998, p. 19). The agricultural sector in particular—where most of the poor in the developing world find their employment—is also likely to benefit from competitive exchange rates. What this suggests is that urban workers in state-owned enterprises and protected industries are most likely to oppose the stabilization program, rather than the rural laborers.

But we must emphasize that this urban group of industrial workers hardly constitutes the poor in most emerging market economies. Urban workers belong to the middle-income groups that, with unemployment, face perhaps the greatest risk of falling into poverty. Consequently, it is they who face the greatest immediate risks as economic reform proceeds.

There may also be an important temporal dimension associated with the changes in employment levels. By opening the economy, structural adjustment will lead to an increase in frictional unemployment for urban workers in the short run, but over the long run, growth within the emerging private sector should lead to greater employment opportunities. The task of social policy is thus to ease that transition period, through unemployment compensation and perhaps education and training programs (Veldkamp 2001).

These points lead to the central hypothesis regarding the incidence of social policy in emerging market economies: the political demand for social policy has come not so much from the poor, but rather from workers in higher-income groups who feared that economic reform would plunge them into the lower-income brackets. These groups, who perceived that their protected jobs would disappear and that wages would fall, were most vulnerable in the face of stabilization and reform measures.

THE DEBT CRISIS IN LATIN AMERICA AND THE BIRTH OF THE WASHINGTON CONSENSUS

The debt crisis that erupted during the summer of 1982 was widely perceived as the greatest challenge to the international banking system that the world had faced since the Great Depression. At the time, many observers viewed the international financial system as a veritable house of cards, ready to be blown down at any instant by the balance of payment crises in Mexico, Brazil, and Argentina. The world's largest commercial banks had made loans to these governments that were a multiple of their shareholders' equity; thus, debt repudiation would make the banks insolvent (Kapstein 1994, pp. 81–102).

During the early 1980s, U.S.-led industrial world governments and international financial institutions focused their efforts on ensuring that commercial banking collapses be avoided. Thus, the IMF and the banks were encouraged to make new loans to developing country debtors in an effort to maintain liquidity. By 1983, however, these sources of funds were drying up; that year the commercial banks provided only $2 billion in loans to Latin America, down from the $23 billion provided a year earlier.

A new approach to the debt crisis was thus required by the mid 1980s, one that emphasized a shift from austerity to renewed economic growth. In Latin America, per capita levels of gross national product had declined significantly, and calls were being heard for the creation of a "debtor's cartel." Peru had elected a socialist leader, Alan Garcia, who acted to repudiate his country's debt burden, and the Reagan Administration was worried about the spread of communism in the region under the influence of the Castro regime in Cuba and the Sandinistas in Nicaragua.

With this as background, U.S. Treasury Secretary James Baker launched a new initiative in October 1985 at the annual World Bank/IMF meetings held in Seoul. Baker said that the key to managing the debt crisis was economic growth in the developing world, and to that end he proposed a package that tied substantial new loans from the commercial banks and international institutions to domestic policies that focused on structural adjustment, deregulation, and export promotion—reforms that John Williamson would dub “the Washington Consensus” (Williamson 1990).

Williamson’s personal view of the consensus was that it emphasized fiscal discipline; changes in public expenditure priorities (with an increase in spending on education, health, and infrastructure, and a cut in subsidies); tax reform; and other already-mentioned market-friendly policies. Yet missing from the Williamson list was any mention of social or labor policy reform, leading one to draw the conclusion that these issues were simply not of concern to public officials.

That view, however, would be somewhat overdrawn. Indeed, in commenting on Williamson’s initial consensus list, Stanley Fischer stressed the importance of poverty-reduction policies in the process of economic reform. “Emphasis on poverty reduction,” he said, “has increased in recent years and will continue to do so. The concern with poverty reduction goes beyond the belief that economic growth will reduce poverty, to the view that specific policies . . . can reduce the number of poor people in a given country and should be used for that purpose” (Fischer 1990, p. 27). To be sure, nobody in Washington ever asserted that the impact of adjustment on the poor should be forgotten, but it is also the case that Fischer perhaps was protesting too much. For both theoretical and policy reasons, the fate of the poor was not a topic of overriding importance in 1980s Washington. From a theoretical standpoint, it was widely believed that application of the market liberalization formula would be sufficient. And from a policy perspective, the developing world’s poor population simply did not have much political voice in Washington or any other capital city.

Williamson responded to Fischer’s remarks by casting doubts over the extent to which concerns with poverty and income inequality were high on official Washington’s agenda. Further, even if they were a priority agenda item, Williamson was skeptical about the effectiveness of the policy instruments that might be used by governments or the international financial institutions in order to advance egalitarian objectives. He noted the “shocking indifference to distributional issues that characterized the early years of the Reagan administration” and remarked that egalitarianism is “the issue par excellence that divides left from right, and on which the politicians therefore should be expected to make the substantive decisions” (Williamson 1990, p. 414). This disregard of distributional issues was hardly out of character. The Reagan years witnessed the largest increase in the U.S. income inequality since the 1920s—a point which troubled but little those in power—and it would have been indeed odd had they paid greater attention to inequality and poverty elsewhere.

The issue we wish to treat here concerns the relationship between structural adjustment measures and social policy. How did the reform packages of the 1980s affect poverty and income distribution in Latin America, and what was done to lessen any negative impact? Were the rich made richer and the poor made poorer by the debt crisis and its aftermath? How did issues of political economy influence social outcomes of the crisis?

The reverberations from the debt crisis were felt both in macro- and microeconomic terms: the crisis influenced incomes of households and firms, and, of course, the overall GDP. As Table 3.1 illustrates, by 1990, per capita income levels were significantly less than at the beginning of the decade in Argentina (–23 percent), Peru (–22 percent), and Mexico (–10 percent). Brazil’s GDP per capita was at about the same level, and only Chile had grown. Not surprisingly, the 1980s became known in Latin America as “the lost decade.”

During the height of the debt crisis, the proportion of Latin Americans living in poverty rose significantly. In the greater Buenos Aires region of Argentina, the ratio of those in poverty increased from 10 percent in 1980 to 25.2 percent in 1987 (Lustig 2000, p. 3), and in Brazil from 34 percent in 1979 to 41 percent in 1989 (Lustig 1995, p. 6). In Chile, despite the overall growth, the number considered extremely poor or indigent doubled, from 11.7 percent in 1979 to 23 percent in 1988 (Arriagada and Graham 1994).

Income inequality also widened across the continent: from a Gini coefficient of 0.41 in Argentina in 1980 to 0.48 in 1989; in Brazil from

Table 3.1 GDP Per Capita Levels in Selected Latin American Countries, 1975–2000

	1975	1980	1985	1990	1995	2000
In $PPP						
Argentina	10,775	11,476	9,356	8,513	10,940	11,693
Brazil	4,234	5,199	4,937	4,985	5,400	5,657
Chile	4,199	5,528	5,347	6,809	9,520	11,069
Peru	4,263	4,177	3,689	3,026	3,770	3,967
Mexico	5,671	6,996	6,608	6,497	6,400	7,713
(1970=100)						
Argentina	107	114	93	88	109	116
Brazil	145	178	169	181	185	193
Chile	86	113	109	136	194	226
Peru	111	109	96	85	98	103
Mexico	117	145	137	131	133	160

NOTE: Data in $PPP are expressed in 1995 prices.
SOURCE: World Bank DECPO (B. Milanovic) database.

0.58 in 1981 to 0.63 in 1989 (Morley 1995); and in Chile from 0.44 in 1978 to 0.52 in 1988 (Arriagada and Graham 1994). As Alain de Janvry and Elisabeth Sadoulet have written of the Latin American case, “recession is systematically devastating on poverty and inequality” (de Janvry and Sadoulet 2001, p. 37).

As that comment suggests, it must be emphasized that the debt crisis and ensuing reform policies were *not* accompanied by offsetting redistributive measures in most Latin American countries. As Figure 3.1 illustrates, in the wake of the debt crisis social transfers as a share of GDP fell in Argentina and Brazil by about 1 percentage point. Since GDPs in both countries declined, the real social transfers decreases were even greater. In Chile, transfers decreased by even more, although the drop there was driven primarily by the discontinuation of public works programs that, at their peak, covered more than 10 percent of the labor force.

Democratization has often been cited as the primary driver behind the renewed interest in social policy in Latin America that emerged in

Figure 3.1 Social Security and Welfare Transfers in Three Southern Cone Countries, 1980–2000 (as share of GDP)

SOURCE: IMF Government Financial Statistics, and World Bank SIMA database.

the early 1990s (see Brown and Hunter 1999). Indeed, important political and economic reforms were associated with the democratization process, but military governments also had signaled social policy as a priority (and it should not be forgotten that these countries all had fairly developed social policies, generally established by authoritarian regimes in earlier periods). In Chile, for example, "the military government defined the eradication of poverty as the priority objective of its social policy" (Raczynski 1994, p. 91), and, of course, it fathered two of the most significant social-sector reforms that any emerging country has undertaken: emphasis on targeting of the poor, and the privatization of the pension program. In Brazil, it was the statism of Getulio Vargas in the 1930s rather than contemporary democratization that inspired the development of social policy (Malloy 1991; Draibe, de Castro, and

Azeredo 1995). And in Argentina, the populist Peron regimes similarly expanded social transfers (Lo Vuolo 1995).

In any case, the first priority of the democratic regimes was to restore economic growth in the face of debt negotiations that impelled countries to move toward macroeconomic stabilization coupled with greater openness. The objective of these policies was to "remove any sort of insulation from the market determination of the allocation of resources" (Morley 2000, p. 16). The effects of these reforms would be to remove the heavy hand of the state from many aspects of economic life.

Export-oriented policies and more competitive exchange rates could have worked to the advantage of unskilled labor. But Morley suggests two reasons why labor was skeptical about the benefits of the neoliberal strategy. First, "[r]ising real wages are a clear threat to growth in the export model . . . Countries embarking on the outward-looking growth path are making their wage levels hostage to wage levels and labor costs in other countries." Second, capital openness, which accompanied trade openness, would likely increase "the bargaining power of capital in its negotiations with both labor and the government. That is likely to be regressive" (Morley 2000, p. 17). Capital could use its "exit" option to press for lower wages, along with a change in tax policy that would shift the burden toward labor.

Governments initially were not willing to compensate the immediate losers from reform. As Lustig (1995) writes, governments have choices with respect to how they approach adjustment policy and austerity, and in the short run little was done in Latin America to shield the lower half of the income distribution from its effects. Social spending was not maintained during the period of crisis and adjustment (see Figure 3.1), and even indirect transfer programs, as through the educational system, were regressive, benefiting the middle and upper classes. Further, the decentralization of social services, often encouraged by the international lending institutions, was misguided in the face of limited financial resources and administrative capacity (Lustig 1995, p. 32). The result "of the economic crisis is that in country after country, where the bottom or the middle range's [income] share shrank, the income share of the top 10 percent increased, sometimes substantially" (Lustig 1995, p. 5).

During the 1980s, Latin American governments (other than Chile) made little effort to target social assistance payments to the lower-income brackets (Szekely and Fuentes 2002). This is not surprising, since "redistributive initiatives are likely to encounter political resistance" (Lustig 1995, p. 34). Academics had argued, however, that even if direct redistribution were not politically feasible, elites might be willing to support widespread access to education, if only out of the self-interested view that human capital formation would lead to a better educated labor force, greater export competitiveness, and thus to greater wealth generation for the elites. After all, East Asia had provided an example where compulsory education seemed to play a significant role in fostering that region's postwar growth.

But in Latin America, a very different set of educational policies and priorities were undertaken. Morley writes that "Asia put a lot of its education dollars into eliminating the bottom tail of its educational distribution and universalizing secondary education. Latin America let most of its young cohorts leave school after primary, using the money instead to expand university coverage" (Morley 2000, p. 11). In short, education spending has been regressive.

Despite—or perhaps because of—this relatively grim history, by the 1990s there was growing evidence that social policy was once again beginning to emerge as a topic of broader concern in Latin America. The Economic Commission of Latin America (ECLA) reported: "One of the positive features of the decade is the effort to increase social spending, which has reached unprecedented levels. This advance has been accompanied, moreover, by attempts to reform social services, whose results have been variable." During the 1990s, eight countries on the South American continent were devoting more than 10 percent of GDP to social spending (Franco 2000, p. 9).

What has driven this acceleration in spending? Several factors have some explanatory power. First, Lustig notes the urban riots in Venezuela in 1989 and in Argentina in 1993, and the Chiapas rebellion in Mexico in 1994, as indicators of the potential for violence when poverty and inequality increase (Lustig 1995, p. 3). In this view, social spending represents an attempt to quiet the masses; however, that would suggest that transfers have indeed been targeted at this group, and we have little evidence of this occurring. Second, we have already discussed the possible role of democratization in increasing social spending by inducing median voters to vote for fiscal policies that benefit them and their families. Further, democratic politics tend to reward politically well-organized interest groups, and the pattern of social spending may indeed reflect the distribution of political power. Third, the resumption of growth, if even at a lower rate than before the 1980s, allowed Latin American governments some additional breathing room, and that "room" was used to increase social transfers. Spending in Brazil increased from 7 percent of GDP at the end of the 1980s to 12 percent 10 years later. Over the same period, social transfers in Argentina doubled from 4 to 8 percent of GDP (see Figure 3.1). Economic growth, however, was not accompanied by a decrease in unemployment, which remained above the levels of the 1980s in Argentina, Brazil, and Chile. Given this relationship between unemployment and reform, the international financial institutions made social policy in general, and antipoverty programs in particular, a focus of their lending programs.

At the same time, as ECLA has observed, a growing number of social policy experiments began to dot the continent. Some of these, like Chile's pension reform, predate the debt crisis and have attracted enormous attention, influencing policy design worldwide. Others, like the Bolivian social funds or the Argentine public works programs, represented local experiments at targeting the poor, which have met with mixed reviews both in-country and by outside evaluators. Still others, like the increase in public expenditures on education in Brazil, seemed very much targeted at the middle and upper classes. In the next chapter, we take a closer look at Chilean pension reform, which is arguably the single most significant social policy development of the contemporary era, but one that clearly has skilled workers as its major beneficiaries.

THE POSTCOMMUNIST TRANSITION

The economic and political transition in Central and Eastern Europe and the former Soviet Union that was launched in 1989 represented, in many respects, the most hopeful event of the 20th century. Never before has an empire so massive as the Soviet one collapsed so peacefully and so quickly, and with so little bloodshed. And never before have so many people simultaneously welcomed the arrival of democratic politics and market-oriented economics, both of which signified greater freedom of choice and an enlarged sphere of personal liberty.

Yet today, the situation across that great sweep of territory provides a decidedly mixed picture. The entire region has witnessed a sharp increase in unemployment, poverty, and income inequality. Women, children, and the elderly have, as a general rule, seen a considerable increase in poverty rates. But with the massive implosion of economic activity and state revenue, "fewer resources were available for the governments to redress poverty through social assistance" (Braithwaite, Grootaert, and Milanovic 1999, p. 164).

This rise in unemployment, poverty, and income inequality was not predicted in the early days of the transition. To the contrary, most forecasts of economic growth were optimistic, and living standards were expected to rise. No less authority than Milton Friedman (1990) wrote: "There is no reason why total output cannot start to expand almost immediately after the totalitarian restrictions on people's activities are removed." These predictions were grounded in the unshakeable logic of market economics: once the Warsaw Pact economies liberated the factors of production and allowed them to gravitate toward their most efficient uses, and once competition was introduced, growth would naturally follow. That belief in the uplifting power of markets was so strong that MIT's Olivier Blanchard has asserted that explaining why growth did not immediately follow on the heels of transition "is the major theoretical challenge facing economists" (Blanchard 1996, p. 117).

That is why social policy received such scant attention at the outset. As one observer has written, "When market reforms were first introduced in Russia, little attention was paid to social policy in the belief that the fall in living standards was only a temporary phenomenon and that they would soon improve, along with the economy as a whole" (Morvant 1996, p. 57). That perception was widely shared not only in the transition countries' governments but in the international lending institutions as well.

In 1991, contrary to most hopes and expectations, real gross domestic product fell by more than 14 percent across Central and Eastern Europe, and by almost 7 percent in the former Soviet Union (Table 3.2). The decline continued for another two years in Central and Eastern Europe and another five in the former Soviet Union. Individual countries did even worse: Ukraine and Moldova registered GDP decline for an incredible 10 years in a row. In the early transition, newly liberalized consumer prices rose severalfold almost in all countries. Currency val-

Table 3.2 Real GDP Growth Rates in Central and Eastern Europe and Former Soviet Union, 1990–1999 (percentage per annum)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Central and Eastern Europe	–8.1	–14.4	–4.3	–1.8	3.9	5.5	5.0	3.1	2.7	0.3
Out of which:										
Poland	–19.0	–11.5	4.2	6.2	11.9	9.7	8.7	11.5	4.8	4.4
Hungary	–8.2	–19.1	–9.8	4.0	9.8	6.6	2.3	11.0	12.5	10.4
Czech R.	–8.2	–22.8	–11.7	–7.4	0.0	7.1	7.6	6.5	1.6	–3.1
Former Soviet Union	–2.5	–6.7	–15.5	–9.8	–13.9	–5.3	–2.6	1.0	–2.9	2.2
Out of which:										
Russia	–0.1	–8.0	–18.8	–16.2	–20.9	–3.0	–4.0	1.9	–5.2	8.1
Ukraine	–0.2	–4.8	–6.4	–8.0	–27.7	–12.0	–5.1	–1.8	–1.5	0.2
Total transition	–3.7	–8.6	–12.9	–7.7	–9.0	–1.9	–0.1	1.7	–0.9	1.5

NOTES: Central and Eastern Europe and the former Soviet Union are each treated as a single entity.
SOURCE: World Bank DECPO (B. Milanovic) database.

ues plummeted. In most countries, tax revenues declined and fiscal deficits increased. Political and economic institutions faltered and were deemed incompetent or illegitimate by many voters, who quickly sought to oust the governments in power. Within this political vacuum, corruption and organized crime began to flourish.

By 1992, many observers—including the IMF—were growing fearful about a political backlash against the transition. The Fund stated that "the magnitude and duration of the contraction of output has been more severe than expected at the start of the reform process" (IMF 1992, p. 45), and the threat of "reversibility" arose in Eastern Europe along with the lurking question of "who lost Russia?". The election of a new, communist-led parliament in Lithuania in 1992 was followed by electoral victories by the renamed (and reformed) communist parties in parliamentary races in Poland, Hungary, Bulgaria, and Latvia. Indeed, in 1992 Russian president Boris Yeltsin cancelled a number of regional and local elections that had been scheduled for later in the year, and in 1993 he bombed the parliament and killed the deputies who questioned the wisdom of his economic policies.

During the earliest years of transition, many countries that were part of the former Soviet Union enjoyed one bright spot in their reform experience: a lid had been kept on unemployment. The situation was different in Eastern Europe, where in all countries other than the Czech Republic, unemployment increased rapidly (Table 3.3). But in the former Soviet Republics, labor markets worked with an almost textbook-fashion flexibility (Layard and Richter 1995): the low wages of workers, coupled with labor hoarding just in case there is a business upturn, and the paternalistic attitude of the managers (Kuznetsov and Kuznetsova 1996) caused enterprises to maintain employment levels; further, the privatization of large state-owned enterprises and defense firms had been delayed. By 1993, however, the situation was beginning to change. The transition economies were now culling the bitter "fruits" of economic reform and restructuring in the form of higher levels of unemployment. The IMF noted that the adoption of structural adjustment policies, most notably privatization of state-owned enterprises, had resulted "in a considerable number of dislocated workers, perhaps for an extended period, implying increased expenditures on unemployment benefits, active labor market policies, and social assistance" (IMF 1994,

Table 3.3 Unemployment Rates in Eastern Europe and Russia (percentage of labor force; annual average)

Year	Poland	Bulgaria	Czech Republic	Slovakia	Romania	Hungary	Slovenia	Russia
1991	9.0	6.6	2.8	7.1	1.6	4.1	8.4	0.1
1992	12.9	14.4	3.1	11.3	5.4	10.4	11.6	3.2
1993	15.0	15.9	3.0	13.0	9.2	12.9	14.5	4.3
1994	16.5	14.1	3.3	14.5	10.8	11.4	14.5	5.5
1995	15.2	11.4	3.0	13.7	9.9	10.6	14.0	6.2
1996	14.3	11.1	3.1	13.1	7.3	11.0	13.9	7.0
1997	11.5	14.0	4.4	12.9	7.4	10.5	13.3	7.8
1998	10.0	12.2	6.1	13.8	9.2	9.5	14.5	8.6
1999	12.0	13.8	8.4	17.5	11.3	9.7	13.6	9.3
2000	14.0	18.1	9.0	18.5	11.2	6.4	12.2	8.7

SOURCE: World Bank DECPO (B. Milanovic) database.

p. 79). Note the emphasis on the need for accompanying social policies, something absent from the economic reform discourse that informed the response to the Latin American debt crisis of the 1980s.

It is symptomatic of the growing sense of crisis surrounding the transition that in 1994, for the first time in its history, the IMF devoted a section of its authoritative *World Economic Outlook* to the topic of social safety nets. That same year, the World Bank published a major study of labor markets and social policy in transition (Barr 1994). The Fund now stated explicitly that "there is a need to establish social safety nets to protect the most vulnerable members of society. This is necessary not only to facilitate the restructuring of enterprises *but also to sustain public support* (emphasis added) for the transition process" (IMF 1994, p. 79).

For many workers in transition economies, particularly in Russia, the primary issue was not so much social benefits—which were paltry in any case—as unpaid wages and pensions. Arrears were in the trillions of rubles, and the sums when paid were diminished by inflation. Further, basic services, like health care, were eroding, and mortality rates were climbing, particularly for men aged 40–44, the very workers most affected by transition. In 1996, Russian First Deputy Prime Minister Viktor Ilyushin described his country's "current socioeconomic situation as disastrous" (Kapstein 1997, p. 182).

Yet how could transition governments support the rising social burdens associated with unemployment, ill health, and an aging population? On top of everything else, the transition has been launched at a poor moment in the region's demographic history. The population in almost every country was growing older and sicker, particularly in the face of gruesome environmental conditions. As governments faced their social problems, none loomed larger than a pensioner population that had to be supported by a shrinking workforce. In that context, it would not have been surprising if some officials viewed rising mortality rates as the grim upside to a seemingly impossible fiscal challenge.

Considerations of political economy would strongly shape social policy outcomes across the transition world. In some countries, notably Poland, both pensioners and workers were treated reasonably well during the early transition years, reflecting their degree of political voice. Unemployment benefits were relatively generous in Poland, covering 70 percent of a worker's wages for six months and then falling to 60 percent for an additional six months. Pensions were indexed against inflation. These developments were hardly coincidental: given a political and economic structure in which both workers and pensioners were relatively well organized, they were able to extract sizeable transfers from the state (Kapstein and Milanovic 2000).

Indeed, this record partly undermines Adam Przeworski's assertion that the Polish transition occurred without reference to welfare state policies. Such policies were indeed instituted or maintained, although they very imperfectly covered the most needy citizens; in Poland, social assistance to the bottom income decile covered less than 10 percent of the poverty gap (that is, the gap between their incomes and the poverty line), as opposed to 29 percent in Hungary (Milanovic 1999, p. 132).

As this discussion suggests, the type and effectiveness of social policy has varied enormously across the transition economies. But "despite these differences, a number of similarities can be drawn. By and large, the former Soviet Union countries have retained a greater emphasis on subsidies for housing and utilities, while Central and Eastern Europe countries have relied more on cash benefits. Means-tested social assistance schemes based on a minimum income guarantee have been more prevalent in Central and Eastern Europe . . . There is also limited evidence that the Central Asian countries rely more upon informal safety nets, such as extended family networks, than other countries" (Andrews and Ringold 1999, p. 22).

These points remind us of an additional factor that has been important to social policy reform, and that is geography; more specifically, proximity to the European Union. The Central and Eastern Europe countries, closest to Western Europe and aspiring to European Union membership, have adopted the closest thing among transition economies to the continental welfare state model. The countries of the former Soviet Union, reflecting the defense-industrial structure imposed on the nation by Stalin and his successors, must continue to find ways of supporting millions of people who live far from any center of international economic activity. Finally, the Central Asian republics, reflecting the social values found in that region, have stressed a decentralized form of insurance policy, relying heavily on family networks and communities.

These differences, however, should not mask certain distressing commonalities. As the United Nations (UNDP 1999) reports, "the process of transition in the region has had huge human development costs." These include the fall in life expectancy, the rise in deadly diseases, and the increase in poverty. Among the transition economies, Slovenia enjoys the highest human development index—it is 35th among the world's nations. But Russia is rated 72, and many of the Baltic and Central and Eastern European countries are even lower, while the Central Asian republics are all well below 100 (UNDP 1999, p. 4).

As depressing as these outcomes are, a number of important social policy experiments have also been launched across the transition region, especially in the area of pension reform, where the fiscal demands for change are overwhelming. Some of these hold promise for delivering social insurance and assistance more efficiently and effectively in the future, but we also raise some skepticism with respect to the most touted reform, namely pension fund privatization. We discuss these reforms, and our reservations, in greater detail in the following chapter.

THE ASIAN FINANCIAL CRISIS

Unlike the Latin American debt crisis and the postcommunist transition, the Asian financial crisis that erupted in Thailand in July 1997

Table 3.4 GDP Per Capita Levels in Selected Asian Countries, 1996–1999

	1996	1997	1998	1999
In $PPP				
Indonesia	4,031	4,153	3546	3,521
Malaysia	9,555	10,017	9051	9,353
South Korea	12,075	12,557	11713	12,870
Thailand	7876	7,701	6,907	7,144
(1995=100)				
Indonesia	106	109	93	93
Malaysia	106	111	100	104
South Korea	105	110	102	112
Thailand	104	102	92	95

NOTE: Data in $PPP are expressed in 1995 prices.
SOURCE: World Bank DECPO (B. Milanovic) database.

was lodged within a group of countries that were viewed as economically sound by the international financial community. Of the three crises, it was the mildest (in terms of overall output loss) and the shortest, as almost all Asian countries affected by the crisis returned to positive growth within two years (see Table 3.4). This group of nations, which had launched their economic development at the end of World War II with per capita incomes that were lower than those found in most of the Southern Hemisphere, had managed to transform themselves into export powerhouses that had enjoyed a generation of sustained growth. High levels of education, relative income equality, deep wells of social capital, farsighted governments, and a dynamic entrepreneurial class had supported this evolution and made the region a model—although the one that was never emulated elsewhere—for emerging market economies everywhere.

The countries of East Asia had adopted a very distinctive political and economic trajectory. Democracy did not seem to be highly valued in the region, and some economists would argue that the sort of enlightened authoritarian regimes that characterized several of these countries were well suited to making the hard choices necessary for the early stages of economic development. These policy decisions included coerced land reform, the suppression of wages (and of labor unions), and reduced consumption as industrial structures were put into place. Nor were these economies characterized by free market principles. To the contrary, protectionism, industrial policy, close linkages between government and business, and tightly controlled financial markets were all common as the East Asian region entered world markets through export-led growth (Haggard 1990).

Strangely, while the East Asian miracle seemed to contradict both market and democratic principles in many essential ways, the region's success was uniformly applauded by economists and international bureaucrats, and lessons from it were drawn in the hope of inspiring other countries, especially those that had adopted relatively protectionist stances, as in Latin America (World Bank 1993). Credit rating agencies also held most of the Asian economies in high esteem, as did banks and other financial institutions. Private capital inflows rose from an average of 3.5 percent of GDP in Indonesia during the years 1991–1995 to 6.3 percent in 1996; the comparable figures for Korea were 2.8 to 5.1 percent, and for the Philippines 3.3 and 9.4 percent (Berg 1999, p. 4).

It was in the midst of these seemingly good times in mid 1997 that the Thai economy began to give signs of serious weakness and that the decision was made to devalue the Baht. An economic crisis went on to sweep much of the region before moving on to other emerging market economies from Russia to Brazil. In 1998, real GDP declined by almost 15 percent in Indonesia, 10 percent in Malaysia, 7 percent in South Korea, and 10 percent in Thailand (see Table 3.4). Academics and public officials today continue to debate the causes of this sudden and severe shock.

Fundamentally, there are three contending positions on the principal causes of the crisis. First, there are those analysts who emphasize "fundamental deficiencies in the affected countries," such as macroeconomic imbalances and institutional weaknesses, including an absence of banking regulation and a tradition of "crony capitalism" (Berg 1999, p. 4; Kapstein 1999). In short, this interpretation emphasizes domestic policy failures.

A second position holds that the crisis was the result of "financial panics—rational 'bank runs' against otherwise viable economies" (Berg 1999, p. 50). Those who panicked include both domestic and foreign investors seeking to protect their assets. They fled the Asian economies once they came to believe that there were insufficient foreign exchange and gold reserves to cover existing claims. This view therefore gives pride of place to behavioral factors and their influence on the investment climate.

Yet a third interpretation, which in some ways contradicts the previous view, privileges international forces, particularly the perverse role of the IMF as a lender of last resort, which creates a situation of moral hazard within the financial community. Since investors believe they will be bailed out by the IMF, a permissive environment for global capital has been created without the requisite supervision. International investors, who are incapable of accurately assessing risk/return trade-offs, recklessly place millions of dollars in loans and investments in countries about which they know relatively little (Cronin 1998; Kapstein 1999). A bubble is eventually created, which ultimately must burst as investors recognize the disjunction between asset prices and underlying values.

Despite disagreements over proximate causes, almost every analyst and policymaker has referred to the Asian crisis primarily as a financial one. And in defining the shock in those terms, the policy priorities for governments were also highlighted, including the establishment of better banking supervision domestically and the strengthening of the "international financial architecture" on a multilateral level. The building blocks of that improved financial architecture would include the provision of more financial data by countries and international institutions; greater transparency of IMF decision making; more rigorous global banking standards; and finding ways of "bailing in" rather than "bailing out" private sector actors (Rubin 1998).

This general consensus, however, failed to mask deeper public disagreements over the specific IMF policies that were advocated to deal with the problems at hand. Fiscal tightening and higher interest rates seemed inappropriate in light of government budgets that were not severely imbalanced, and in fact could be expected to worsen both the macro performance and the social consequences, especially in terms of unemployment and poverty. World Bank chief economist Joseph Stiglitz was among the IMF's most vocal critics, asserting that the Fund's policies were driving Asian firms into bankruptcy. Academic researchers, including Jeffrey Sachs, also criticized the Fund's encouragement of higher interest rates (Sanger 1998).

The financial crisis and accompanying policy debate generated a great deal of academic research and journalistic commentary, focusing mainly on capital markets and their regulation. For many months, the social impacts of the shock were "relatively neglected" (Lee and Rhee 1999, p. 1). This reflected, in part, the lack of specific information about the effects of the crisis on poverty and unemployment. Even as late as January 1998, six months after the crisis erupted, researchers were complaining that "only limited information is currently available for assessing its social impact" (Lee and Rhee 1999, p. 14).

Soon it was becoming clear, however, that the economic contraction was having a severe impact on employment and incomes. Strikes, food riots, and political demonstrations brought that message to every government and international institution. Between 1997 and 1998, the unemployment rate rose from 2.2 to 5 percent in Hong Kong; 5.4 to 15 percent in Indonesia; 2.7 to 7 percent in Korea; and from 4 to 6 percent in Thailand (Birdsall and Haggard 2000, p. 18). Real per capita household income fell by 20 percent in Korea and by 12 percent in the Philippines between 1997 and 1998; in Indonesia it fell by 24 percent (Knowles, Pernia, and Racelis 1999, p. 15).

Still, the feared rise in poverty did not occur to the degree initially predicted. According to a study prepared by the Asian Development Bank,

> "[t]he crisis appears not to have produced the sharp increases in absolute poverty that some predicted for three reasons. First, the impact of the crisis in most countries has been greater among urban populations whose income levels tend to be considerably above the poverty line. Second, the massive devaluations that initiated the crisis have benefited the agricultural sector . . . and this is the source of income for most households near the poverty line. Third, poverty reduction brought about by robust economic growth in the past appears not to be so easily reversed" (Knowles, Pernia, and Racelis 1999, p. 40).

Indeed, those most affected by the crisis were those who were "*relatively* well-off to begin with" (Birdsall and Haggard 2000, p. 22, italics in original).

In the face of these social developments, it was not at all clear to Asian governments what, if any, social policies should be put into place. Many Asian officials expressed wariness about creating a complex set of social safety nets for lack of administrative capacity, financial resources, and an inability to target those who were most vulnerable. Further, there was an ideological resistance to the idea of open-ended cash transfers that were thought to promote idleness. The governments were more willing to entertain (as they have previously, such as during the land reform) the idea of direct capital transfers—build a house for the poor, pay for education. There was also a belief that kinship networks would be adequate to meet the social task, and ironically it was feared that the state could disrupt these networks by taking on expensive welfare functions.

The social policy response, therefore, was in large measure a reflection of the capacity of domestic groups to organize and extract their demands as part of the economic reform process. Among the Asian economies, it was in a rapidly democratizing South Korea, where labor was best organized and most capable of influencing the policy debate. Korea already had in place a minimal social safety net, which by introducing unemployment benefits would be expanded during the crisis as the state sought to secure labor support for its programs. That response is discussed in greater detail in the following chapter.

4
Reforming Social Policy: The Cases of Chile and Korea

Our analysis thus far has rested at a fairly aggregate level. We have used a relatively broad brush in discussing the data and recent history with respect to social spending in emerging market economies. Our objective has been to provide evidence on behalf of the hypotheses we have proposed. But the policy choices and hard trade-offs behind the numbers often remain obscure. In order to cast light on these issues, case study analysis may provide a useful complement.

Case study research also has its limitations. Questions are appropriately raised about case selection and the generalizability of any results and lessons. Further, even if clear lessons emerged from our cases, applying them to other countries presents an entirely new set of challenges.

But our objective in this chapter is more modest, and that is to present two of the most influential examples of social policy reform in the emerging market context, namely pension reform in Chile and the development of unemployment insurance in South Korea. These cases have been widely touted by the international financial institutions—mainly the World Bank—and a host of think tanks as providing potential models for other countries, and are therefore suggestive of some of the main currents in social policy reform (see, for example, Pinera 2000). Around the world, pension privatization—which Chile made famous—is perhaps the major social policy buzzword, while the provision of unemployment insurance, once deemed irrelevant to most developing countries given the “informality” of their labor markets, is now under study. These cases also offer interesting lessons in political economy, supporting the general theme of this study: that social policies tend to be targeted at groups that are politically well organized.

They also provide powerful illustrations of how social policy reform and market liberalization, particularly globalization, are linked. For its part, South Korea illustrates the demand for increased social protection, particularly protection against unemployment, in the face of greater financial openness. The sudden outflow of capital from that country left it exposed to the ravages of a brutal recession, leading to a sharp rise in the number of jobless and a fall in real wages. Despite the economy-wide effects of the recession, we will show that unemployment insurance and other unemployment benefits were mainly targeted at, and secured by, that country's "industrial aristocracy."

The case of Chilean pension reform is different in that it was used in part as a way of *linking* Chile with the global economy. The Chilean government expected that pension reform would lead to capital market development and deepening, which in turn would help open the economy to greater capital inflows from abroad; at the same time, a cap was established on the percentage of pension assets that could be invested abroad. But here too, the main beneficiaries were to be found among urban skilled workers in the middle-income strata. As the data in Chapter 2 illustrated, openness may be viewed as a particular threat to this group, which also corresponds to the median voter in middle-income developing countries.

In both cases, we perceive strong links between social policy, globalization, and median voter preferences. On the one hand, social policy may be used as a buffer against sudden changes in the terms of trade or global economic conditions more generally; on the other, such policy instruments can be shaped to promote greater openness. The net effect of unemployment compensation and pension reform is to ensure consumption smoothing over the worker's lifetime, providing greater economic security in the face of rapid and seemingly uncontrollable change.

PENSION REFORM: CHILE AND BEYOND

Until quite recently, old age and poverty were closely linked almost everywhere in the industrial world. While these countries, beginning with Germany and Denmark, launched pension schemes in the late 19th and early 20th century, in most cases only minimal levels of income support were provided, and the schemes were not always universal in coverage. Over time these programs have been expanded, and now a growing number of workers in the advanced economies also have access to private retirement plans. Further, medical insurance programs provide important coverage for the aging, meaning that the costs associated with frailty, illness, and hospitalization are shared to a large degree. As a result, old age no longer necessarily implies a dramatic lowering of living standards, and in many industrial countries the aging population now enjoys tremendous savings and purchasing power, not to mention political clout.

In the developing countries, including the high-performing economies of East Asia, a very different picture of economic security in old age emerges. While several countries developed pension schemes independently or as part of their colonial heritage quite early in the 20th century—especially in Latin America—many more have been lacking in this form of social insurance altogether. Thus, the link between old age and poverty remains strong for most of the world's aging population.

But this situation may be on the cusp of radical change, thanks mainly to democratization, as politicians seek votes from their aging populations. According to the ILO, "non-contributory pensions have been proposed by political parties with a view to gaining or consolidating electoral support" (ILO 2000, p. 117). In a number of new democracies, including all Central European countries (Poland, Hungary, Czech Republic, Slovakia, and Slovenia), pensioners have been relatively successful in having their voices heard, thus ensuring that their payments are fully indexed to protect them against inflation.

Given fiscal weakness throughout the developing world, the budgetary implications of these promises have caused growing concern among international lending agencies. At the same time, because existing programs were generally limited to government officials, state-sector workers, and the "labor aristocracy" and did not reach those who labored in the informal sector, it was feared that any further expansion must lead to virtual bankruptcy. These concerns were brought into sharp relief in 1994, with the publication of the World Bank's landmark study, *Averting the Old Age Crisis*. There, the Bank advocated the development of "multipillar" pension schemes, in which the public, pay-as-you-go program would be augmented by a personal, defined contributions (DC) system managed by private insurance companies and other financial providers. In addition, there would be a public pillar guaranteeing only a minimum pension to those who have not contributed enough and are poor. The optional DC pillar would provide an opportunity for the rich to "top off" their pensions by buying additional private insurance. The system was thus supposed to be flexible, financially sustainable, and tailored to the needs of different segments of the population.

The potential success of privatized retirement funds had already been demonstrated by Chile, which had completely privatized its pension scheme a decade earlier. Indeed, the Chilean case posed, and continues to pose, the fundamental issue of whether the state has a useful role to play in the provision of old-age insurance, or whether it can cede that particular ground to the private sector. In an important sense, the developing countries have raced ahead of the industrial world in conducting this particular social policy debate.

There have been few policy innovations anywhere that have had as much global resonance as Chilean pension reform; only Margaret Thatcher's privatization of British industry offers a rival. The Chilean reform has provided the cornerstone for many other nations' efforts at modernizing their pension programs, not just in South America but around the world (see Pinera 2000). Russia, Argentina, Mexico, Bolivia, and Kazakhstan are among the countries that have adopted or contemplated the adoption of the Chilean scheme. Because of its widespread impact, a careful analysis of the costs and benefits associated with the privatization of Chile's pension plan is of particular importance to social policy research.

The Chilean pension program has enjoyed global influence for a number of reasons, including the charisma of its founding father, the Harvard-trained economist Jose Pinera; the particular nature of its introduction in the context of a politically brutal but economically reform-minded military government; its bold, even extreme, approach to the problem at hand; its exemplification of policy innovation; and its direct confrontation with a near-universal problem, that of aging populations. In the face of powerful political economy interests—i.e., aging voters—it seems that policy reform in this particular domain has become one of the toughest challenges for most western governments. Chile poses that greatest of policy challenges: if we can do it, so can you. As Sarah Brooks and Estelle James have written of Chile's influence, "Successful reform in one country increases the perceived probability of success . . . in other countries" (Brooks and James 1999, p. 21). That view is supported by the Organisation for Economic Co-operation and Development's (OECD) Monika Queisser, who asserts, "The demonstration effect of the Chilean pension reform promoted a wave of pension reform in Latin America" (Queisser 1999, p. 8).

The new Chilean pension scheme was introduced in 1981 by the regime of Augusto Pinochet as part of a new social security reform act of 1980. While its author, labor minister Jose Pinera, would later emphasize the neoconservative political motivations behind the policy shift ("The basic problem of the (old) system . . . lay in its collectivist conception of man and society"), the timing was very much driven by the impending bankruptcy of the existing regime (Pinera 2000). An aging population, a crazy quilt of existing social security systems, and a relatively generous pay-as-you-go plan for many workers meant that financial reserves were inadequate to meet growing demands (Raczynski 1994, p. 60). Indeed, Pinera "went on radio and TV weekly to convince workers that they did not want their money to continue disappearing into a 'black hole'" (Brooks and James 1999, p. 26).

The new system, the first of its kind anywhere, "was one of individual capitalization of quotas, in which the old-age pension results from contributions a worker accumulates over his/her economically active life through the payment of mandatory social security quotas, plus the return from investments made with these contributions by the Administrators of Pension Funds (AFPs)." These AFPs, regulated by the state, are corporations whose sole purpose is to invest the funds that they have received. The AFPs are in competition, and workers can move from one AFP to another at any time. Participation in the system is mandatory for all *salaried* employees, meaning that a significant percentage of the population remains outside the benefit scheme (Raczynski 1994, p. 60). It is notable that the quasi-totality of the self-employed, informal sector workers, and all others whose participation in the system is not mandatory, have opted *not* to join the system. As we shall argue below, this provides a healthy dose of skepticism regarding the attractiveness of the system—in a similar way that the citizenry of the former socialist countries by "voting with their feet" undermined the claims of their leaders.

Bureaucrats, academics, and public officials have claimed that there are advantages of shifting from a defined benefit to a defined contribution plan, and from a pay-as-you-go plan to a fully funded pension system. As Queisser notes, "Advocates of the new funded pension systems with individual retirement accounts see the following advantages: . . . a tight link between contributions and benefits which can reduce distortions in the labor market; a potentially positive impact on national savings and thereby on economic growth; the mobilization of domestic resources available for long-term investment, which can contribute to capital market development; and finally, through the build-up of a pool of investable funds, a boost for the development of the domestic financial sector" (Queisser 1999, p. 12).

Although the Chilean privatization is widely hailed as a model for reform in other countries—Russian president Putin is reportedly considering a pension reform modeled on Chile—there have also been several problems associated with it. First, the transition from the pay-as-you-go system to the new program has been costly and continues to be so. These costs have been estimated at between 3.4 and 4.5 percent of GDP (Uthoff 1999), the higher number reflecting armed services pensions because the armed services had opted out of the new system, maintaining their privileged, state-insured scheme. The transition entails paying pensions to those who were grandfathered under the old system, while diverting taxes to the newly established individual savings accounts. There is thus a mismatch in the flow of funds. This is one reason why very few countries have adopted the pure Chilean scheme, opting instead (e.g., Poland and Latvia) for the notionally funded pension programs whereby the link between contributions and benefits is preserved as in a funded system, but pensions continue to be paid out of current taxes. Other countries (e.g., Croatia) have simply added a "second pillar" on top of the existing pay-as-you-go model, thus increasing choice for the employees.

Second, the state remains liable for paying social assistance pensions to those who never contributed to the existing pension scheme, and the same will go for the new scheme as well. At present, only about 60 percent of employed Chileans contribute to individual savings accounts; it is notable, in contrast, that well over 70 percent contributed to the old system (Mesa-Lago 2002, pp. 1312–1313).

Third, the country's "private system is plagued by high administrative costs, which are in part passed on to workers in the form of high commissions" (Kay 1999). These high costs were supposed to be driven down by competition, but that has had less of an effect than expected. No less than a quarter of workers' contributions is "eaten up" by administrative and marketing costs (Mesa-Lago 2002, p. 1315). This is severalfold more than under the old state system, and for the two systems to yield the same return to workers, the new system must significantly outperform the old in order to merely compensate for the large administrative costs. In addition, growing concentration among AFPs is casting doubt on the future level of competition among the administrators, and the likelihood that the clearly wasteful charges would be reduced.

Fourth, the complete privatization of the scheme means that the quality of a worker's retirement depends completely on financial market performance. But if stock and bond markets undergo a prolonged period of low growth or decline, many workers will only be able to count on little more than the state pension of $60 per month.

Fifth, employers have abused the system, failing to pay their fair share. According to a report in the *Financial Times*, "Recent estimates put contribution arrears at about $500 million, or $2,000 for every employer involved" (Mulligan 2001). The president of the country has now had to occupy himself with finding ways to get firms—especially small and medium-sized enterprises—to contribute what they owe.

Finally, some have argued that the Chilean scheme is unfair to women. Women earn less, spend more of their working years at home raising children, and live longer; as a result, they can expect a poorer retirement than men. On the flip-side, there is the counterfactual question of whether women were better off under the old system. The real issue at stake concerns the savings that are available to the household in retirement, and it may be that Chile's privatized scheme will prove superior over the public pension system. The issue of women's pensions, however—and the broader question concerning those who are not part of the private system—raises the sorts of distributive issues that have been the object of relatively little research (Kay 1999).

Yet there have been major benefits associated with the Chilean reform as well, although some of these are also now the topic of debate. Perhaps the most widely claimed benefit concerns the increase in the savings rate. Since the 1980s, when the program was first introduced, the county has built up a pool of billions of dollars of savings. This pool has supported the development of financial markets and, in turn, of the real economy. Indeed, pension reform and the financial markets may, under a sound regulatory environment, provide a virtuous circle, with retirement funds providing the savings needed for corporate investment (Queisser 1999, pp. 18–19).

Some economists, however, cast doubt on the extent to which Chilean pension reform has caused an increase in the nation's savings rate. World Bank pension expert Robert Holzmann, for example, has argued that “economic growth owing to higher total factor productivity and capital accumulation and better labor market performance is at the heart of the higher private savings rate” (cited in Gray and Weig 1999, p. 28). For their part, Orszag and Stiglitz (1999, p. 5) label as “myth number 1” the assertion that “[p]rivate defined contribution plans raise national savings.” A similar verdict is made by Mesa-Lago, who very perceptively shows how even the supporters of the private fully funded system have shifted ground from the initial claim that the system “does” raise the savings rate to saying that “it offers a unique opportunity to raise national savings” (Valdes-Prieto 2001; quoted in Mesa-Lago 2002).

Aside from the potential economic benefits associated with the Chilean reform, the political benefits have also been touted, though of course these may be more hotly contested. Jose Pinera has put the arguments most strongly: “Pension privatization led to a radical redistribution of power from the state to civil society and, by converting workers into individual owners of the country’s capital, has created a political and cultural atmosphere more consistent with free markets and a free society” (cited in Mulligan 2001). Ironically, of course, that freedom was put into place by an authoritarian regime, which gave its workers no say in the matter, destroyed the trade unions, and whose very key backers (the Army) decided to stay out of the new system.

As already noted, the apparent success of the Chilean pension reform in saving the retirement system from collapse has provided a model that continues to attract global interest. But it should be emphasized that few countries have gone so far as Chile in adopting a pure, privately funded model. Instead, most other countries have adopted multipillar schemes, in which the defined benefit component has been maintained. Some authors argue that Chile was able to ram through its particular approach only because it was an authoritarian regime, and that democracies have proved incapable of winning the political support for such an extreme reform (Queisser 1999, p. 29). While that may be the case, it could also be that the problems and inequities of the Chilean system have been additional causes for concern.

It has generally been recognized that the export of the Chilean model is severely constrained by domestic political economy factors. Following a trip to Russia, for example, Jose Pinera noted that “Russian pension reform needs to be fitted to Russian conditions . . . the most salient feature of Russia's economic situation is a justifiable lack of trust in the nation's financial sector, which essentially no longer functions" (Pinera 2000, p. 67). While he suggests that Russians could overcome this problem by investing in global index funds, even this instrument requires a degree of regulation and supervision that may be beyond the interest or capacity of Russian authorities at the present time. Indeed, the capacity of the Chilean state to carry out radical economic reform may be one of the most important but least exportable aspects of that nation's model.

We might also observe that the Chilean pension reform was nested within a much broader set of structural adjustment projects for every sector of the economy. Liberalization and marketization were pursued across the board. That may have made a radical approach to pension reform more palatable to the citizens, as it appeared consistent with other economic policy measures; in essence, everyone was under the gun of economic change at the same time. Of course, the fact that social security taxes were lowered as the shift to a defined contribution system was made also helped win popular support.

The distributive questions associated with Chilean pension reform are among the more difficult ones to settle. While the policy was certainly targeted at urban workers in formal employment—our key point regarding the likely beneficiaries of social transfers—it is uncertain whether those left outside have been made worse off. To the extent that retired persons actually live within the context of an extended family that provides them with some financial support, and to the extent that at least some of these family members may be better off due to economic change, then the overall effect has been positive. A fuller understanding of these distributive consequences remains a major research task for students of the Chilean reform, and by extension for all students of social policy in emerging market economies.

UNEMPLOYMENT INSURANCE IN KOREA

The socioeconomic concept of unemployment is fundamentally a modern, industrial one, reflecting the migration of workers from rural to urban areas and the rise of factory work (Kapstein 1999). Once lodged in these cities, workers lost the social safety net that families and kinship networks had traditionally provided in the countryside, and over time the state's role as welfare provider expanded. As with old age, unemployment was associated with a sharp drop in living standards, while mass unemployment was coupled with political agitation. In the wake of the Great Depression, a number of industrial countries introduced unemployment insurance schemes, reflecting the growing tensions within their societies at that time. These programs arose in the face of demands by socialist parties and labor unions for some income security, given the instabilities associated with modern industrial capitalism. And of course the Soviet Union would put an end to unemployment altogether.

In developing countries, unemployment insurance has been slower to arrive, particularly because their labor markets remain largely rural and/or informal. The ILO reports that "very few of the world's workers benefit from unemployment protection and those that do are mainly concentrated in the industrialized countries [while] most of the workforce in developing countries are underemployed workers in rural areas and in the urban informal sector, who have virtually no protection against unemployment." They constitute about one-quarter of the global workforce, or between 750 million and 900 million people (ILO 2000, p. 147).

There has been considerable debate in the academic literature on developing countries with respect to the concept of unemployment and, as a result, regarding the necessity for unemployment insurance as an income stabilizer. A useful review piece states that economic research on the labor markets of these countries has been powerfully shaped by three assumptions: 1) that the poor cannot afford to become unemployed; 2) that labor markets in developing countries are sufficiently open and flexible so as to offer jobs at prevailing wages; and 3) that unemployment reflected a search for jobs (often by the more highly educated) with high earnings (often in the public sector where wages failed to respond to changes in the economic environment) (Turnham and Erocal 1990, p. 17).

These assumptions have remained quite powerful over time. Writing in 1996, Pierre-Richard Agenor stated that the differences between labor markets in developing and developed countries were substantial and this meant that "standard labor market concepts used in the industrial world (such as employment and unemployment) do not necessarily have the same meaning" (Agenor 1996, p. 263). Agenor emphasized the importance of employment in the rural and informal sectors as key distinguishing features. As a result, in the developing world, "[j]ob insecurity is pervasive, underemployment is high, wages are highly flexible, and workers get very few benefits" (Agenor 1996, p. 264).

The alleged flexibility and openness of the labor market also cautioned economists against recommending any increase in western-style unemployment insurance schemes. After all, these programs placed a wedge into the market, disrupting the adjustment process. As a result, there were very few such programs in operation prior to the 1990s (with the partial exception of Latin America) and very little academic analysis of them.

In recent years, however, there has been much more attention paid to the problem of unemployment in developing countries, and to the possible need for creating or expanding unemployment insurance. This has been largely due to two seemingly contradictory effects. On the one hand, as economies have grown and become more democratic, public demands for welfare spending have increased. As the World Bank noted in 1995, "past development success has created a need to upgrade labor standards, and in particular to develop rational forms of job security" (World Bank 1995, p. 123). On the other hand, a series of economic shocks, including the Latin American debt crisis, the postcommunist transition throughout the former Soviet bloc, and the East Asian financial crisis, added urgency to the social policy debate. Traditional labor market regulations, such as those protecting workers from arbitrary dismissal (which were widespread in Latin America, while, of course, full employment was the rule in the communist world) gave way to structural adjustment programs, which compelled firms and government agencies to make layoffs. In East Asia, governments saw economic growth as the best social insurance policy; with the sharp downturn in 1997–1998, the fragility of that model became apparent.

In Korea, which had a highly industrialized workforce, particular attention was paid to the social safety net in the wake of the financial crisis. The rapid downward spiral in the real economy caused a fall in wages, an increase in unemployment, and rising poverty (Hur 2001). Between October 1997 and October 1998, the official unemployment rate in South Korea climbed from 2 percent to over 7 percent of the working population, with thousands more entering the informal economy (Abrahart 2001, p. 78). “In January 1998 alone, 3,323 corporations were declared insolvent . . . most of them small and medium-sized enterprises” (Gupta et al. 1998, p. 12). Of course, unemployment and lower wages influenced the economic prospects not just of the job-holders, but of their families as well.

In facing the downturn, Korean President Kim Dae Jung proposed on December 25, 1997, the establishment of a Tripartite Commission, representing unions, employers, and government, to deal with the issue of labor market adjustment. That commission was launched shortly after the New Year, and by March 1998 it made sweeping proposals for the expansion of the existing unemployment insurance program. It should be emphasized that this process was strongly supported by the conditionality clauses found in Korea’s letters of intent signed with the IMF during the crisis; in the fifth letter, signed February 7, 1998, the parties agreed that “additional social safety net expenditure will be provided in the context of the Tripartite Accord” (Wang and Zang 1998).

Korea already had a rudimentary social safety net in place before the Asian financial crisis struck. It consisted of both social insurance (e.g., for old age, disability, and unemployment) and social assistance. But these schemes were hardly universal. For example, unemployment insurance was only available to workers in firms with more than 30 employees, while it excluded some categories altogether (such as those working part time or less than 30.8 hours per week). Overall, nearly 50 percent of the nation’s labor force was thus deemed ineligible. As a result, the existing program supported workers who in many cases enjoyed either lifetime employment security or generous severance programs from industrial employers. In fact, as with other Asian economies, much of the social safety net that existed was provided by the largest firms.

The implementation of unemployment insurance, along with a variety of active labor market measures, was a relatively new development in Korea, having been introduced only in 1995 (Hur 2001). The launching of these labor insurance programs coincided with Korea’s application and admittance to membership of the OECD in 1996, which required that a certain level of social protection be put into place. The Organization also requested that Korea “reform existing laws on industrial relations in line with internationally accepted standards, including those concerning basic rights such as freedom of association and collective bargaining.” At the same time, it expressed concern over the repeated arrests of trade union leaders, noting the “lack of trust among social partners” (Martin and Torres 2001, p. 359).

That lack of trust was of particular concern during the country’s financial crisis. A failure to achieve some degree of consensus on labor market reforms could doom the government’s economic recovery program and fuel a lack of investor and international confidence in the country’s leadership. This gave the unions some degree of leverage within the context of the Tripartite Commission. The unions thus sought a major expansion of social insurance programs for their members.

Beyond the lack of workforce coverage, specific concerns with respect to the existing unemployment insurance program in the wake of the 1997 crash concerned the total amount of funds available, the duration of payments for the unemployed, the amount of benefit, and the complete lack of insurance coverage for those in the informal sector. The government and Tripartite Commission attempted to respond to these concerns in short order. Premiums were raised to ensure the integrity of the unemployment fund; unemployment insurance was extended to small enterprises (although few of these actually complied with the legislation requiring them to make payments to the unemployment fund); and durations and wage replacement levels were increased (Abrahart 2001, p. 79). The minimum unemployment benefit was raised to 70 percent and later 90 percent of the country’s minimum wage, while the ceiling was established at 56 percent of the average daily wage; thus, benefits went from a low of $9.50 per day to a maximum of $25 per day. It should be noted that the minimum cost of living in Korea is determined to be $7.50 per day, so even the minimum benefit puts workers above the poverty line.

These modifications, however, failed to reach those who were most vulnerable to the crisis: those who were newly employed or who were school-leavers seeking their first job, and those in the informal sector of the economy (Abrahart 2001, p. 79). One of the striking characteristics of the Korean labor market (like many developing countries, but perhaps surprising given Korea’s status as an OECD member) is that the formal employment to population ratio is relatively low. Women and youth are underrepresented in the labor force, and over one-half of all workers are considered outside “regular” employment, either filling temporary jobs or laboring in the informal sector (Martin and Torres 2001, p. 363). Thus, while workers in regular employment received some level of protection against the scourge of joblessness, those outside that privileged zone received almost nothing.

Korean authorities also responded to the rise in unemployment through the introduction of public works programs. These programs reached several hundred thousand workers, but “the incidence among total participants of well-educated individuals and prime-age workers has been relatively high” (Martin and Torres 2001, p. 372). Wages were set well above the national minimum, making them attractive to workers with more than basic skills.

As a result of these policies and programs, the financial crisis in Korea had particular distributional effects. More-educated workers were less affected than those who had only reached the end of compulsory schooling. The young and old were more affected than the middle-aged. There were declines in primary and middle school enrollment due to a lack of income to pay for schooling, while high school and tertiary school enrollment, which mainly drew from the middle- and upper-income groups, actually rose. Spending on tutoring, an important component of Korean education, also reflected these distributional impacts, with lower-income groups cutting such spending much more than did higher-income groups (Knowles, Pernia, and Racelis 1999, p. 26).

In terms of the payment of unemployment benefits, these same distributional patterns also emerge. That is, while “marginal” workers—the young, the less educated, the nonunionized, and those in the informal sector—were severely affected by the recession, they were not the primary recipients of the expanded social insurance program. For example, less than 7 percent of the recipients of unemployment insurance had only a primary school education, while over 30 percent of the recipients had obtained high school or university training (Lee and Rhee 1999). As Lee and Rhee (1999, p. 6) have written, “targeting the core unemployed group is politically difficult in reality. In building up the social safety net, the core group does not have a political channel to represent itself. They are usually non-union members not represented by workers’ representatives at the negotiation table.”

These findings, of course, mirror a general theme that we have developed throughout this study: that social policy generally focuses on relatively skilled, formal sector workers, and not on the most vulnerable members of society. In the Korean case, social insurance schemes favored those groups that were most likely to prove capable of derailing the economic reform process—unionized workers in heavy industry. Those outside the "labor aristocracy" had to rely on social assistance or the social capital of kinship networks. But as John Martin and Raymond Torres of the OECD have written of Korea, "social assistance programs do not cover adequately those in need and [social assistance] benefits are below the poverty line" (Martin and Torres 2001, p. 373).

The Korean story is therefore one in which the sorts of political economy considerations that we have focused on loomed large. And we note that two close students of the Asian financial crisis, Nancy Birdsall and Stephan Haggard, have drawn similar conclusions, stating that "none of the political systems had strong parties representing the interests of those most seriously affected by the crisis in an ongoing and institutionalized way. Many of those hit are difficult to organize anyway—such as in the small-business sector—in the absence of highly pluralistic and well-developed democratic processes" (Birdsall and Haggard 2000, p. 29).

What conclusions can be drawn from the Korean experience with the creation and expansion of unemployment insurance programs? On the one hand, the ILO's general contention that unemployment insurance plays "a substantial role in coping with the unacceptable levels of hardship caused by rapidly escalating unemployment" (ILO 2000, p. 161) is certainly correct. While far from perfect—the number of unemployed who actually received unemployment benefits during the financial crisis was rather low—Korea had ramped up its scheme quickly, with strong support from domestic unions and the international community. On the other hand, political economy considerations appear to have strongly influenced the execution of the unemployment insurance scheme and complementary labor market programs, since the main beneficiaries were those located in middle- rather than low-income groups.

GENERALIZING FROM CASES?

Obviously, two cases as distinct as the ones we have presented do not allow for sweeping generalizations. But these examples, bolstered by other evidence, are suggestive of some of the problems and prospects associated with social policy reform. Much of the evidence gathered in transition and emerging market economies leads to the conclusion that social policy has not yet been targeted with the poorest and most vulnerable citizens in mind. These people have been unable to establish a sufficiently loud voice in newly democratic societies to win much in the way of scarce financial resources. Curiously, the church—whether it be Roman Catholic or Orthodox—does not seem to have played a decisive role in social policy debates in those economies where it is otherwise a prominent actor, despite occasional calls for "social justice," as with the liberation theology movement that once proved attractive to many in Latin America.

Yet it would be wrong to conclude that little or nothing has been or is being done. Social policy experimentation is now widespread, especially in the area of pension reform.

With respect to unemployment programs, including insurance, there are also some good signs, the first of which is renewed interest in these schemes among both academics and policymakers. For a generation, unemployment was treated as if it simply didn't exist in the developing world context. But a combination of factors, including industrialization, globalization, and democratization, have led to a new generation of studies of labor markets and their operation (see World Bank 1995). These have forced analysts and officials to recognize the existence of joblessness alongside widespread underemployment, and have also cast doubt on some long-held assumptions about labor market openness and flexibility.

Accompanying this renewed concern with unemployment has been widespread policy experimentation. Beyond efforts to create or expand unemployment insurance programs, a host of active labor market measures have been enacted, including the provision of employment services, the expansion of public works projects, job creation subsidies, incentives for labor mobility, and associated programs to support education and training (ILO 2000).

It should not surprise us that social policy seems to target those who apparently have the most to lose from economic reform. As Alvaro Forteza and Martin Rama have written,

> Most economic reforms create winners and losers. Workers in protected industries, in the public sector, or in banks are amongst the

> most obvious losers, at least in the short run. In countries where these workers are a large and well-organized group, resistance to reform could be fierce . . . the appropriate complement to adjustment programs would not be labor market deregulation, but rather the introduction of mechanisms that compensate the workers affected by the reforms . . . Examples include job separation packages, early retirement programs, and unemployment benefits. (Forteza and Rama 2001, p. 3)

But these policies must also raise the costs of labor, with potentially serious implications for employment levels and labor market adjustment. There are also budgetary costs which are particularly high in the case of active labor market policies and which put them out of the reach of many poorer and even middle-income countries. Clearly, these factors suggest the need for further research and analysis of "optimal" social policy design when it comes to unemployment compensation.

5
Conclusions and Policy Recommendations

Over the past decade, social policy has become a mainstay of the global economic agenda. It was at the core of the World Bank's year 2000/2001 *World Development Report*, and in recent years industrial countries' leaders have highlighted its importance at their annual summit meetings. In part, this reflects a growing public concern with the process of globalization, which is increasingly being viewed as a policy with severe distributive consequences both within and between countries.

In the face of these public and policy concerns, economists have undertaken a number of research studies aimed at identifying the causal effects of market liberalization and greater openness on employment, poverty, and income distribution. This research has uncovered a near-global trend toward greater income inequality, driven largely by technical change but also promoted by the forces of economic integration. Specifically, as argued in Chapter 2, it appears that in the poorest countries, trade opening has marginalized the unskilled labor and increased returns to workers in the upper-income deciles. In contrast, in middle- and high-income countries it is the upper-income groups that seem to be the immediate (relative) losers from liberalization and openness. Given their political influence, and given the budgetary possibilities that exist in these societies, it is not surprising that these groups have been the primary beneficiaries of social transfers.

The dramatic economic shifts of the past decade have had differing temporal effects on different groups of workers. In many countries, economic reform and privatization have had at least the short-term effect of ending the jobs and eroding the wages of workers in the formal sector and public sphere. These are the workers who have felt most vulnerable to economic change because of the sectors where they worked and the fact that they enjoyed job security and a host of state-provided social benefits. They have understandably been most eager to win social insurance guarantees from the state, including reliable pension schemes and unemployment compensation. Their concerns have resonated both domestically and internationally; indeed, according to a World Bank report, “the international community has paid more attention to pension and unemployment insurance programs than to safety net policies” (Andrews and Ringold 1999, p. 39).

In this book we have argued that social policy reform has largely been targeted at this “striving class,” rather than the poor. The poor have several disadvantages in lobbying for social protection, including a lack of political influence and a lack of jobs in the formal economy. Further, efforts at targeting the poor may backfire, since those who are in higher income brackets and who are more politically powerful will reject fiscal programs that do not benefit them directly (Gelbach and Pritchett 1997).

As in the industrial world, therefore, social policy reform has been a supremely political process in the emerging market context. Newly democratic societies have demanded greater social spending, and that spending has been targeted at the most vocal and well-organized groups, as one would predict (Brown and Hunter 1999). To the extent that public spending helps the poor, it is a byproduct of programs that primarily support the best organized voting blocs.

This chapter seeks to make policy recommendations for governments and international institutions on the basis of our empirical findings and case studies. In advancing these ideas, we are fully cognizant of the administrative, fiscal, and political impediments to their realization. There is no shortage of “new ideas” concerning social assistance and insurance, but meaningful reform is harder to come by.

Still, undue pessimism would not be warranted. Policy change has occurred in many places around the world, even if economists and political scientists have a hard time accounting for those political and institutional shifts. Indeed, one of our chief recommendations for further research would be to assess a larger set of cases of “successful” reform (than we have been able to undertake here) in the interest of uncovering causal factors.

In the first part of the chapter, we put forth our recommendations for specific changes in social policy, focusing on pension reform and unemployment compensation. We then take a broader view of the role of the international community. We conclude with some thoughts concerning future research.

PENSION REFORM: IS PRIVATIZATION THE ANSWER?

In recent years, the idea of pension privatization has become something of an obsession with public officials, international bureaucrats, and academics. Given all its alleged long-term benefits, it would also seem to be the social policy reform that is most capable of overcoming political economy obstacles to its implementation. Yet it was not the case, and in most countries around the world pension reform has proved difficult to advance.

This is because such reform usually entails a hike in both the retirement age and the contribution rate, and privatization of at least one pillar of the pension scheme. The IMF, for example, has stated that pension reform in the postcommunist transition economies should include "increasing the share of employee contributions (and) . . . an increase in pension age, together with elimination of early retirement and disability provisions" (Gupta et al. 1998, p. 11).

But each of these policy recommendations may be called into question. For example, increasing the retirement age in countries like those in the former Soviet Union, where life expectancy has been declining, will undoubtedly seem unfair to those who have worked for the bulk of their adult lives. This group of workers will also be likely to balk at the further tax hikes required to meet "reformed" contribution rates. Pension privatization could prove a disaster unless accompanied by supporting measures like strict financial regulation, and the shoring up of state-supported social insurance schemes that ensure retirees with some minimal payout. In addition, financial sophistication of the public and the existence of relatively well-developed capital markets are also needed—and often wanting. Without them, fraudulent dealings by the investment funds, low return to workers' contributions, and thus an ultimate government bailout—effectively transferring resources from many contributions to a few rich fund managers—seem a likely scenario. While these preconditions (regulation, financial markets, sophistication of the public) may not seem overly ambitious, they may well be beyond the capacity of most emerging market economies. As we have seen in the Chilean case, even the most successful cases of pension reform have failed to tackle some crucial issues.

There is another fundamental problem with funded schemes. Their returns are much more volatile. While a pay-as-you-go system may run into trouble because of the shrinking number of current workers, a funded system can, in a matter of months, lose half or more of its assets. Recent declines in world stock markets have reminded us that financial markets can—and do—go down. As Krugman (2002) recently pointed out, privatization of pensions seems like a very good idea when stocks are rising. It seems almost as if one can get something for nothing. But when stocks lose 70 percent of their value in two years, the idea loses some of its shine. The fact that pressures to privatize social security in the United States are still on the table, Krugman writes, can be explained only by the huge expected private gains of a few financial institutions that would manage more than 130 million individual contributors' funds.

The bottom line is that pension privatization does not remove the state from the retirement equation, but rather redefines its role and obligation. The state must still provide a minimum pension in any and every case, and it must regulate the newly privatized marketplace. The failure to do so will only lead to trouble down the road for the newly designed scheme.

We would assert that the debate over pension reform should focus in the first instance on improving the state-supported system. In other words, rather than moving straight to privatization, we would argue in favor of the so-called "parametric" reform of the pay-as-you-go system, which, through increases in contributions or declines in benefits, changes in the retirement age, and lesser redistribution between different categories of pensioners, would make the pension system healthier, more fair, and sustainable over the long run. Further, in many emerging market economies, the elderly do not receive any pension benefit at the present time, and old age is impoverishing. In these cases, universal pension schemes may be required for both political and economic reasons (see ILO 2000, p. 118).

We are not, of course, necessarily antiprivatization or antidefined contribution schemes. We are aware of the rot in many state-run systems, in transition economies as elsewhere. In many countries, pensions funds (while the numbers of contributors was high compared to the number of pensioners) have been raided by the governments. By the time the system was beginning to face net outflows, there was no money left. But we do not believe that the governments that have misused the pay-as-you-go systems will suddenly change their ways and, when the pension systems become privatized and funded, provide the necessary oversight protecting an individual’s life-savings. Moreover, we have strong grounds to believe that even worse abuses may be committed (because the temptation provided by the existence of a large pool of savings to be managed is greater) by an unholy alliance of fund managers and politicians. Thus, rather than getting better, the situation would, in our opinion, become worse.

Now one might think that “globalization” of the pension scheme might have merit in those cases where national governments cannot be counted on to make the necessary reforms. That is, the market could be opened to foreign pension managers, associated with major banks or insurance companies. While we can see why this approach might be seen as theoretically attractive, it is unlikely that the globalization option could provide a replacement for existing systems anytime soon. It would open a whole Pandora’s box of other problems, including possible transfers of savings from poor countries to the rich, and moral hazard issues whereby the western-dominated institutions like the World Bank and the IMF could force the governments of the poor countries to bail out large western pension funds in the same way that Indonesia was allegedly pressed by the IMF to bail out U.S. banks. This would make the pensions of millions of Brazilians depend on the probity and investment acumen of a few bankers in New York.

WHAT ROLE FOR UNEMPLOYMENT INSURANCE?

In the developing world, formal programs of unemployment compensation have received relatively little attention from policymakers or academics. The rural structure of labor markets, and the large size of the “informal” job market, have made such programs appear to be of little importance. Indeed, in those countries that had such schemes, coverage was generally limited to the public sector or to large enterprises, and the payment was often trivial. As a recent Inter-American Development Bank (IADB) report has concluded, “it is doubtful that significant progress can be made in substantially extending [unemployment] coverage as long as the majority . . . are in the informal sector of the economy” (IADB 2000, p. 90).

Economists also advanced the perverse argument that unemployment insurance is of little value to those who live at the bottom of the income distribution. This is because “a given percentage drop in consumption is more burdensome the higher the initial consumption” (Hamermesh 1992, p. 36). But that assertion is redolent of Edgeworth’s bizarre claim that the marginal utility of income is increasing in income because the rich are more knowledgable and thus able to better enjoy fine things in life! Since the drop from near-poverty to poverty can be catastrophic for individuals and their households, such bizarre theories ought to be rejected.

To the extent that global financial shocks and structural adjustment policies have made workers more vulnerable to job dislocation, the case for unemployment protection in developing countries has become more compelling. The informal networks that once provided social insurance may not be able to bear the weight of repeated crises. Moreover, these networks tend to lose importance as the process of development (modernization) proceeds.

One important argument for unemployment insurance is that it can help to reduce labor market rigidity. Fuentes and Szekely (2001, p. 14) state that Latin America, for example, “is a region with very inflexible labor markets,” and this has impeded the progress of economic reform. In a path-breaking analysis, economists at the IMF have found that “institutions that make unemployment more attractive can speed up the process of job reallocation between low-productivity jobs in the public sector and high-productivity jobs in the emerging private sector,” thus speeding the process of structural adjustment (Garibaldi and Brixiova 1998, p. 299). They found that in those transition economies that had relatively generous unemployment schemes, such as Poland, job destruction in the state sector made workers with skills more readily available to foreign investors and to the domestic private sector. In countries without such benefits, workers tended to remain with their existing employers for longer periods of time, placing friction in the way of reform. Far from discouraging workers from seeking jobs, which is a common complaint about unemployment insurance in Western Europe, well-designed unemployment insurance programs may be efficiency-enhancing.

Further, the hypothesis of an "efficiency wage" has undermined the textbook approach that there is a single wage rate and that employers are hypersensitive to any upward push on the rate. Aghion and Blanchard (1994), for example, have, in the early stages of transition, proposed a model that offers an "optimal speed of transition," whereby the speed of restructuring is limited by the ability to shed workers who are paid unemployment benefits. The cost of these benefits is financed by additional taxes that are borne by the new private sector. The faster the state-sector restructuring, the higher the tax needed to finance the unemployed, and the slower the growth of the private sector. Yet that model has hardly found much resonance in real life, since unemployment benefits—even when the unemployment rate had stayed in double-digit figures—have seldom been a very important deterrent to the creation of the new business. The private sector has complained of legal uncertainty and unpredictability and of high taxes, but a 1 or 2 percentage point premium assessed on the net wage has not been deemed significant.

Our discussion of South Korea in the previous chapter also suggests the important political hypothesis that the provision of unemployment insurance can play an essential role in making economic reforms acceptable to important interest groups. Since it is organized workers in the formal sector who are most likely to suffer from market liberalization, at least in the early stages, they will be highly motivated to demand social insurance and assistance programs. Unemployment insurance, when supplemented by active labor market policies, thus becomes a bridge to new skills and new jobs.

Unemployment insurance programs must be designed in the context of particular labor market institutions and with full recognition of the fiscal burdens they entail to workers, employers, and the state. Further, the implementation of an unemployment insurance scheme certainly does not obviate the need for active labor market policies and broader, employment-generating measures, of both a macro- and microeconomic nature. Labor economists have much to contribute to the debate over optimal program design, and we believe that further research on this topic, with more careful case study analysis and evaluation of the unemployment insurance programs that are now in place in the developing world, would prove useful.

PRIORITIES FOR THE INTERNATIONAL COMMUNITY

The international community (by which we refer primarily to the major bilateral donors, international financial institutions, and international nongovernmental organizations) will undoubtedly have a prominent voice in future discussions over the direction and content of social policy. But that contribution also carries with it the seeds of the "north–south" (or "east–west") conflict. The international community could decide, for example, that some "leveling" of social standards is necessary, which could be seen by developing countries as a form of disguised protectionism. Still other observers fear that the international community, led by the United States, will play an even more intrusive role in promoting democracy around the world, a regime type that seems to be consistent with increased social spending and the promotion of equal opportunity—objectives that are highly valued in the west but not necessarily by leaders everywhere (Rotfeld 2000). The globalization of social policy thus carries with it normative baggage that could imply a future clash of values among nation-states.

More likely, the international community will define for itself a somewhat more modest role, yet one that is still intrusive. Specifically, we can expect social policy concerns to remain part and parcel of conditional lending packages, in an effort to make structural adjustment politically palatable. Birdsall (1999) has suggested that the international financial institutions could well become more heavy-handed in their conditional lending, attempting to slash those subsidies that favor the rich and in turn force public spending in a pro-poor direction. While there has been a great deal of rhetoric along these lines, our expectation is that social spending will in fact remain directed toward politically salient groups, such as skilled workers, and that international lending to support pension reform and unemployment compensation will continue, if not increase.

From a technical perspective, the leading international financial organizations should consider a major effort at data collection and data comparability with respect to social policy. At the present time, valid questions can still be raised about the quality and comparability of cross-country statistics on social spending. It would be useful to match the increased rhetoric about the importance of social policy with a commitment to getting more and better information on the amount of social expenditures using a standard international classsification. More analysis on the incidence of social spending is needed as well.

In conclusion, we have argued that economic change in emerging markets from Latin America to Eastern Europe to Asia has increased the demand by relatively skilled workers in the formal sector for greater social spending. The policy response has been largely a function of budgetary capacity. Poor people in poor countries do not receive many social benefits. They face a double handicap: they are poor and thus without much political clout, and their countries cannot afford redistributive policies. Better-off individuals in richer emerging market economies receive a great deal more because they have political influence, they are often the first to be affected by greater openness of their economies, and their governments have the wherewithal to pay benefits.

These governments, with support from the international financial institutions, have sought to respond to that demand for social insurance by putting into play a series of policy measures aimed at compensating workers who may experience job displacement and falling incomes in the early stages of the reform process. It is only over the medium term that these workers can hope to become winners, as the emerging private sector seeks their skills. For better or worse, social policies have been largely designed to help formal sector workers cope with these shifting fortunes, in large part because of this group's organizational capacity.

Yet it would be too much to claim that durable and effective social policies have been put into place in most emerging market economies. Few insurance or assistance programs provide their target groups with more than a bare minimum, and even these sums may not be provided on any reliable basis. Given continuing weaknesses in administration and fiscal policy, many of the social policy victories that organized groups win from their governments are proving hollow (as they currently and most notably do in Argentina), posing risks to the process of economic reform.

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About the Institute

The W.E. Upjohn Institute for Employment Research is a nonprofit research organization devoted to finding and promoting solutions to employment-related problems at the national, state, and local levels. It is an activity of the W.E. Upjohn Unemployment Trustee Corporation, which was established in 1932 to administer a fund set aside by the late Dr. W.E. Upjohn, founder of The Upjohn Company, to seek ways to counteract the loss of employment income during economic downturns.

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ISBN 0-88099-269-7
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