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Market Reform and Social Protection: Lessons from the Czech Republic, Hungary, and Poland

Robert R. Kaufman*

The countries of East Central Europe stand out as examples of the advantages of early and successful transitions to the market. Besides being early reformers, these countries also moved unusually quickly toward the establishment of broad social protection programs intended to cushion the shocks of the transition and to provide some longer-term protection against the uncertainties of the market economy. The success of these strategies has been uneven in terms of their impact on fiscal resources and their overall effect on the distribution of income. However, they must also be assessed in terms of the support they have generated for political and economic system among economically vulnerable but politically influential middle-class, blue-collar, and rural social sectors. In the countries of Central Europe, social transfers directed toward such groups have helped to win their acquiescence to painful adjustments and have facilitated longer-term support for democratic politics.

Keywords: welfare policies; social protection; Central Europe; market reforms

The countries of East Central Europe stand out as examples of the advantages of early and highly successful transitions to the market. Debates persist about the pace and sequence of privatization and economic liberalization, but the rapid exit of these countries from the transitional recessions of the early 1990s and robust economic performance since that time has done much to dispel doubts about the wisdom of rapid and comprehensive market reforms.

Besides being rapid reformers, these countries also moved quickly to establish broad social safety nets intended to cushion the shocks of the transition and to provide longer-term protection against the uncertainties of the market economy. In contrast to the economic reforms, however, these attempts have remained highly controversial. Debates about social policies encompass

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both philosophical questions about the responsibilities of the state and private actors and more pragmatic concerns about the fiscal viability and actual effects of social programs.

Liberal reformers are far from unanimous with respect to specific proposals, but they have generally pressed to shift more of the costs of insurance and protection onto individuals and private providers, to increase competition and accountability within the public sector itself, and to target resources more directly toward the poor.[1] Critics of these reforms are also concerned about increasing the efficiency of social services, but they are much more inclined to defend the underlying principles of social solidarity, egalitarianism, and rights to social protection that characterized the large welfare states in both Western Europe and the old communist world.[2]

Contestation over these issues has produced a somewhat uneasy compromise between these competing principles. Fiscal and other macroeconomic pressures have led to spending cutbacks and the gradual introduction of some measures advocated by liberal critics of the old system. Yet many of the principles of the older system remain intact.

In this article, I examine the evolution of these welfare compromises and their implications for democratic stability and economic growth in three East Central European (ECE) countries: Poland, Hungary, and the Czech Republic. In contrast to the economic reforms, success of these strategies has been uneven. Czech social policies have had a progressive impact on the distribution of income, but growing fiscal pressures since the late 1990s have raised questions about their sustainability. In Poland and Hungary, social transfers have not been well targeted toward the poor and have sometimes locked in politically popular but financially costly commitments.

These programs, however, cannot be evaluated solely in terms of the burdens they place on fiscal resources or their overall impact on the distribution of income. They must also be assessed in terms of the support they have generated for the political and economic system among economically vulnerable but politically influential middle-class, blue-collar, and rural social sectors. In all

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three ECE countries, social transfers directed toward such groups helped to win their acquiescence to painful adjustments and have facilitated support for democratic politics.

Political and economic conditions in other post-socialist and developing countries may impede the implementation of policies that provide comprehensive and equal social protections for all of their citizens. Even under these conditions, however, it should be possible to deploy social transfers in ways that build broad support coalitions and forestall antisystem oppositions. There are at least four lessons that can be drawn from the ECE cases.

First, although fiscal discipline is an essential condition of any successful set of social and economic policies, high social expenditures and moderate deficits do not constitute insurmountable impediments to long-term growth. Indeed, short-term tradeoffs between a balanced budget and compensations to influential political groups can be considered part of the cost of doing business in a democratic capitalist society.[3]

Second, programs broadly targeted toward the middle class and near poor may be important to build support for capitalist democracy. This implies trade-offs with the need to focus resources primarily on the poorest sectors of society. Nevertheless, the capacity of social groups to mobilize politically, as well as absolute need, must be an important criterion in the design and implementation of social protections.

In the third place, it is important to emphasize that broadly targeted programs of social protection that include the middle class and near poor can contribute to the reduction of poverty in at least two ways. Most directly, they may make it easier to sustain political support for the inclusion of the poor as well. In addition, they may aid the poor indirectly by helping create conditions conducive to political stability and economic growth.

Finally, growth alone is unlikely automatically to create new employment opportunities for workers displaced by economic reform. Whether broadly or narrowly targeted, social safety net programs are likely to be most effective when they are accompanied by active employment policies.

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Social protections and fiscal constraints

The priority that policy makers placed on the establishment of broad social safety nets at the onset of the 1990s derived from their commitment to undertake concurrent ("dual") transitions to democracy and to the market. The transformation of highly centralized command economies undermined the employment guarantees and compressed wage differentials that had provided the basis for the comprehensive social protections of the communist era. The social dislocations generated by reform thus threatened to be much more widespread and severe than those experienced in the mixed economies of Latin America. Democratization, in turn, expanded the spaces for potential opponents of these reforms to mobilize and protest. Competitively elected governments could not ignore or repress such protests while remaining democratic.

During the early years of the transition, incoming governments responded to this challenge with significant increases in social expenditures. As consumer and enterprise subsidies were phased out, ECE countries relied increasingly on cash transfers to replace the protections formerly available through these channels. Initially, such transfers included generous unemployment compensation, but this quickly proved unsustainable in the face of high and persistent unemployment. However, much of the slack was taken up by other social programs, including family allowances, child assistance, early eligibility for old-age pensions, and expanded access to disability compensation.

As Table 1 shows, spending on such programs in the ECE countries was more extensive than in the poorer, less democratic countries of the former Soviet Union (FSU), most of which were also slower to move toward the market. Social expenditures in the Baltic democracies was also relatively high, while Romania, the main exception in Eastern Europe, also lagged significantly in both market reforms and the transition to democracy.

Not surprisingly, managing fiscal deficits has been a recurrent economic and political challenge in all of the Central European countries throughout the 1990s and early 2000s, and at various points, all of them have found it necessary to undertake adjustments. Course corrections in Poland and Hungary in the

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Table 1. *Estimates of Cash Transfers and Social Expenditures*

	Cash Transfers/GDP[a]	Social Expenditure/GDP[b]
Poland	17.7	29.5
Czech Republic	12.1	25.5
Hungary	16.5	32.3
Bulgaria	11.8	14.1
Romania	8.9	16.5
Estonia	10.0	26.0
Latvia	11.8	26.5
Lithuania	9.6	19.3
Belarus	8.9	8.3
Kazakhstan	6.9	
Russia	7.5	8.5
Kyrgyzstan	12.4	
Ukraine	9.4	9.8

a. Michael P. Keane and Eswar S. Prasad, "Inequality, Transfers and Growth: New Evidence from the Economic Transition in Poland" (Discussion Paper No. 448, Institute for the Study of Labor [IZA], University of Bonn, Germany, March 2002), 34.
b. Mitchell A. Orenstein and Erika Wilkens, "Central and Eastern European Labor Market Institutions in Comparative Perspective" (Paper presented at the annual meeting of the American Political Science Association, San Francisco, 29 August–2 September 2001), 4, Table 1.

early 1990s, and in the Czech Republic toward the end of the decade, played an important role in stabilizing their economies and consolidating conditions for growth.

Cuts or reallocations of social expenditures have inevitably been components of these adjustments, in part because the capacity to raise revenue is limited by labor market informalization and wage-cost pressures. Following the advice of liberal economists and international financial institutions, governments have introduced greater means testing and more narrowly targeted benefits in many social assistance programs, and they have attempted to establish tighter links between individual contributions and benefits within the pension and health sectors. In the late 1990s, governments in Hungary and Poland partially privatized their pension systems in an effort to avoid long-term fiscal costs of supporting an aging population.

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But macroeconomic adjustments, spending cutbacks, and liberal welfare reforms are only part of the story. The other part, as already suggested, has been the continuing pressure to accommodate blue-collar unions, public employees, pensioners, and larger electoral constituencies whose entitlements and protections had been placed at risk by the economic reforms. Protest, or the threat of protest, from such groups imposed a political cost on adjustment. Consequently, notwithstanding cutbacks, social spending has remained high relative to other regions and post-socialist countries, even at the cost of recurring fiscal deficits.

The trend toward more "liberal forms" of social assistance has also been hedged by compensations for beneficiaries of the old system and by policy compromises that retain some principles of comprehensive coverage and social solidarity. In Hungary and the Czech Republic, benefits available from family allowances and child assistance have been eroded by inflation, but access to these programs remains quite broad.[4] In Poland as well as Hungary, pension reforms included generous guarantees to existing pensioners and to those near retirement, as well as particular categories of blue-collar workers and farmers.

If we take the long view over the past fifteen years, it is clear that the ECE countries have by no means shrunk into the kind of "residual" welfare states that some critics of "neoliberalism" had feared at the onset of the transition. Fiscal restraint and periodic adjustment has played an important role in establishing the foundation for growth. But growth has persisted in the context of moderate deficits and of welfare systems that remain quite large.

Who benefits? The distributive politics of the welfare state

More spending, of course, does not necessarily mean *better* spending. To assess the impact of social transfers and their effect on democratization and market reform, therefore, we need to know how the money is channeled. In this regard, the record varies substantially. Below, I sketch some of the main features of these systems and some of the political factors that helped to shape them. Social policy choices in these countries are in part the results of the

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advice, support, or example of external actors, including the IMF, the World Bank, and the EU. I focus here, however, on domestic political conditions that have also played an important role.

The Czech Republic. Despite a serious financial crisis that broke out in 1997, the social programs in the Czech Republic have been most successful from an equity perspective. The political foundations were based on a compromise forged during the first years of the transition between liberals supporting Vaclav Klaus, then the minister of finance, and social democratic intellectuals led initially by Peter Millar in the Ministry of Labor.[5] The main features of the "social-liberal" compromise were

- rapid price and trade liberalization, fiscal discipline, and a highly popular but controversial policy of "voucher privatization";
- active labor market policies characterized by wage restraint on the part of unions, investment in job creation programs through public works, wage subsidies, and credit to "ailing" firms deemed capable of adjusting to market conditions;
- relatively low unemployment compensation, but a generous and universal system of family allowances and child support; and
- the implementation of a "guaranteed minimum" income, which provided cash transfers to families falling below a minimum threshold.

This strategy, it should be noted, came with economic costs. At least in the short run, voucher privatization created only weak incentives to change existing forms of corporate management and brought little new capital into the economy. Subsidies to ailing firms—intended to shore up employment—created opportunities for insider manipulation and were contributing factors in the financial crisis of 1997.

Despite these problems, however, this mix of social policies worked relatively well throughout most the past decade. The combination of negotiated wage restraint and active employment policies kept both inflation and unemployment low compared to the other ECE countries. Family allowances, the social minimum, and other transfers, have also played an important role in dampening the effects of wage inequalities and in keeping low-income groups out of poverty. Although such programs came under increasing pressure after 1997, the basic elements

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have been maintained into the early 2000s by governments based on uneasy compromises between the Social Democrats and Klaus's liberal party, the ODS (Civic Democratic Party).

To what extent is this experience available as a model for other countries? Unfortunately, many of the political and economic conditions that contributed to successes in the Czech Republic are unlikely to be replicated elsewhere. First, although economic growth in Czechoslovakia had slowed during the 1980s, the country was wealthier than its ECE counterparts, and the post-transition government did not inherit the serious macroeconomic imbalances visible in Poland or Hungary. The Czech Republic was not threatened by the prospect of hyperinflation, as was Poland, and unlike Hungary or Poland, its external debt was fairly modest. Thus, although there was general agreement on the desirability of market reforms, there was less pressure than in the other countries to engage in a full embrace of economic orthodoxy.

A second important factor was the political marginalization of the old Communist Party. Although the party has made a comeback in recent years, its decline during the 1990s opened space not only for liberals around Klaus but also for Civic Forum leaders who looked for inspiration to the strong social democratic legacy of the pre-communist era. Unlike the post-communists of Poland and Hungary, these leaders were not under pressure to demonstrate the credibility of their democratic credentials with uncritical endorsements of liberal market reforms.[6] Their influence within the Civic Forum and then within the unions and the Social Democratic Party does much to account for the sustained commitment to redistributive transfer policies.

The "velvet divorce" of 1993, finally, was a third exceptional factor. The agreement to separate removed some of the political constraints on Klaus's liberal economic program, but it also eliminated the need to deal with the social and political costs of reform in the Slovak lands, which had been the center of Soviet-style heavy industry. As we shall see, the evolution of social policy in Hungary and Poland occurred under less favorable conditions.

Hungary. In Hungary, communist-era experiments with "market socialism" provided a platform for launching a program of

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rapid privatization during the first transition government of Jozsef Antall (1990-1994). The old regime, however, had also established one of the most generous and comprehensive systems of social protection in the world, and Antall sought to sustain or extend this as well. Family allowances and related benefits were declared universal rights, and initially comprised as much as 4 percent of GDP. Antall also substantially extended active labor market policies of the communist period and introduced a new, very generous package of unemployment compensation. As in the other countries, entitlements to old-age pensions and universal medical care were not seriously challenged, despite growing costs and de facto rationing of health services.[7]

As revenues fell during the early recession, these spending commitments proved impossible to sustain. Antall, who was ill and under populist pressure from his own coalition, delayed a comprehensive fiscal adjustment, but he allowed inflation to erode the real value of benefits. Then, as the magnitude of the fiscal crisis became increasingly clear, a new Socialist-Liberal government implemented a tough stabilization package designed by Finance Minister Lajos Bokros.

The “Bokros package” is famous not only for having engineered a turnaround in the Hungarian economy but also for having tackled some of the “taboos” of the Hungarian welfare system.[8] The most controversial initiatives were attempts to introduce means testing into the family allowance program and suspension of the generous maternity leave and child support policies. Partial privatization of the pensions system, although not a part of the original package, was launched in 1997, and was also highly controversial.

For our purposes, however, it is important to emphasize that this challenge met with substantial democratic push-back. As already noted, pension reform passed only after extensive guarantees to existing beneficiaries, older workers in the workforce, and categories of workers covered by special funds. Implementation of cuts in maternity leave was delayed for a critical period by a ruling from Hungary’s powerful Constitutional Court. The provision for means-testing access to family allowances was also later reversed after the conservative government of Victor Orban come to office

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in 1998, and the Socialists themselves promised to raise the real value of benefits when they came back in the early 2000s.

More than in the Czech Republic, however, the defense of the Hungarian welfare state prioritized the protection of the middle class and near poor, rather than those who had fallen into poverty. Important features of the Hungarian party system account for at least part of this outcome. The conservative-nationalist coalitions led by Antall and Orban contained strong populist currents, but their appeals have been directed primarily toward the "traditional middle class." An example is provided by the family policies implemented under Orban in the late 1990s. The elimination of means testing and the restoration of universal rights actually improved access for poor families since many had been unable to complete the complex application processes necessary to receive benefits. But benefits themselves were kept relatively low and were supplemented by generous tax breaks aimed primarily at middle-class families with children.[9]

Hungarian Socialists have in principle advocated more egalitarian policies, but unlike the Czech Social Democrats, they remain under pressure to live down their past. Although they have maintained close relations with post-communist unions, they have governed in coalition with influential liberal allies. As noted, both fiscal adjustment and pension reform of the mid-1990s came on their watch. The appeal of the conservatives, combined with the pressure on post-communist parties to embrace the market, has limited the redistributive aspects of the Hungarian welfare system.

Though the broad targeting of the Hungarian system is inefficient from a liberal perspective, it has important political economy advantages. First, it links wide and politically influential constituencies of near-poor and middle-income groups to the political system. At the same time, casting a broad social security net has brought benefits to some low-income families. An analysis of family assistance programs showed that coverage included almost 90 percent of the "non-poor," but assistance has also reached about 40 percent of families in the bottom decile, a high figure by regional standards.[10] While narrower pro-poor targeting might have saved more money, packages aimed at larger, more

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influential sectors of the population may have helped build vital political support for the inclusion of low-income sectors.

Poland. In the formulation of social policy, governments in Poland have faced more difficult economic and political circumstances than in Hungary and the Czech Republic. In the first place, Poland is a less wealthy country, with a larger—and much poorer—agricultural population. At the onset of the transition in the late 1980s, moreover, exceptionally severe macroeconomic imbalances and the looming threat of hyperinflation gave considerable force to advocates of fiscal austerity. Politically, the country was plagued by electoral volatility, a highly fragmented and undisciplined party system, and ongoing turf battles between the president and a succession of prime ministers.

Not surprisingly, these factors impeded the construction of a coherent and sustainable social safety net. As noted, disability insurance was used as an important cushion for long-term unemployment, but this has carried the cost of locking in extremely costly entitlements. Eligibility was tightened in 1996, but prior benefits were grandfathered, and expenditures remained high because of the bulge of early claimants. KRUS (Agricultural Social Insurance Fund), the noncontributory rural pension scheme, has been a major instrument for fighting poverty in the agricultural sector, but has also placed a heavy burden on fiscal resources. Together, expenditure on these programs comprised approximately 4 percent of the GDP in the early 2000s.[11] Finally, there has been little progress in instituting active labor market policies, or in changing weak or perverse work incentives within existing programs. The result has been that unemployment and poverty rates in Poland remain high, despite relatively rapid growth.

The record looks better, however, when set against the unfavorable political and economic conditions sketched above. Although the Solidarity governments of the early 1990s placed a high priority on "shock therapy," they also struggled to sustain generous compensation packages for families displaced or made vulnerable by the changes. As initially generous unemployment benefits were reduced, ad hoc expansions of retirement and disability programs took their place, and these reached a wide

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portion of the population. According to a survey of the widely respected Public Opinion Research Center (CBOS), about a quarter of adults surveyed in the late 1990s reported that they had benefited in some way from welfare assistance.

Analysis of household surveys conducted by the government statistic office, moreover, show that pension payments and other transfers did in fact reach vulnerable and potentially politically influential sectors. In addition to the elderly, households headed by older workers who had opted for early retirement were especially dependent on pension payments, which constituted up to 80 percent of family income.[12]

From a general welfare perspective, these transfers were not well targeted. As just noted, most transfers went to people in the middle of the income pyramid. Nevertheless, transfers away from the upper income sectors served to reduce the inequalities caused by growing wage disparities in the labor market. More important, from a political-economy perspective, they reduced the shocks to sectors that might otherwise been inclined to oppose market reforms. Such protections did not preclude stormy battles within and between parties; indeed, in recent years, electoral volatility has increased. But they may well have contributed to a deeper stability of the underlying social order, which has remained evident throughout a period of uncertainty and change.[13]

Conclusions and lessons

The end of the transition and accession to the European Union have brought new social and economic challenges to the ECE countries. Going forward, it is predictable that, along with debates over other policy issues, there will be considerable controversy within these countries over the equity, effectiveness, and costs of existing welfare systems. Such debates, however, have increasingly come to resemble those taking place in "normal" democratic countries.

What lessons can we draw for other post-socialist and developing countries that are still struggling to reach that point? Because many of the social challenges faced by these countries

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are highly idiosyncratic, it does not seem useful to recommend specific social policies or programs; as we have seen, in fact, these were quite different among the ECE countries themselves. Several broader strategic points, however, can be gleaned from the experiences I have sketched above.

1. Macroeconomic discipline and growth are essential conditions for social progress and democratic stability, but they are not sufficient to deal with the distributive conflicts that are inevitable consequences of the shift toward a capitalist economy. To smooth such conflicts and to provide the political stability necessary for growth itself, governments need to focus on providing compensation and assistance to vulnerable groups.

2. The provision of social protection is costly, and resistance from taxpayers and other claimants on fiscal resources may make it difficult to keep deficits and public debt within acceptable limits. But the definition of "acceptable limits" should not be delegated to finance ministers alone. At various points, to be sure, tough stabilization measures provided essential course corrections in all of the countries, and pressures for new adjustments have sharply intensified in recent years. Nevertheless, the experience of the ECE countries also shows that it is possible to "muddle through" budget conflicts for considerable periods of time without impeding long-term growth.

3. If social protection and cash transfers are intended to build support for capitalist democracy, it is important to include middle sectors and near poor, as well as less powerful groups within the lowest-income sectors. As we have seen, social policies in both Poland and Hungary fell short of the progressive standards set in the Czech Republic. But especially in the absence of strong social democratic parties, the establishment of an inclusive social contract may require the accommodation of social interests that are more likely than the very poor to organize and vote.

4. Even in Poland and Hungary, however, governments pursued some policies with progressive features. Polish pension benefits shifted income from upper-income families to ones closer to the median; but they did tend to mitigate the overall effects of growing wage differentials within the working population. Middle-income and near-poor families in Hungary gained disproportionately from

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family allowance policies, but some of the benefits reached low-income families as well. In principle, more narrowly targeted programs might have had an even greater impact on poverty and equity. But even where political support for pro-poor policies is weak, it may still be possible to develop policy approaches that minimize harm to low-income sectors and/or that allow some benefits to reach them.

5. Finally, if social safety nets are to remain effective over the long run, they should be accompanied by policies focusing directly on job creation and employment incentives. In this respect, active employment policies pursued in the Czech Republic and Hungary were important components of their overall social strategy. Conversely, as the Polish case suggests, governments should avoid locking in costly pension and disability entitlements not designed to assist or encourage entry into the labor market.

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