

Chapter 1

Introduction

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AT A TIME when most Western governments are seeking to reform their welfare states, developing nations around the world are confronting a growing demand for social policy. The challenges facing these countries run the gamut from establishing social insurance and assistance programs where none had previously existed (as in some Asian countries) to addressing the huge increase in poverty and unemployment that has accompanied economic reform (as has occurred in the post-communist transition states). In all cases, social policies must be shaped in the context of severe fiscal restraints and limited administrative capacity, on the one hand, and an increasing need for policies with respect to pensions, unemployment insurance, and poverty assistance, on the other.

The purpose of this book is to take a careful empirical look at how well emerging market economies in Latin America, East Asia, the Middle East and North Africa (MENA), and Central and Eastern Europe are managing that task. We also examine the role of the international community in providing assistance to this ongoing effort. Lessons are drawn from the history of Western experience, where appropriate.

We argue that social policy (and our focus in these pages is primarily on social assistance and insurance, although some of the authors look at education, health, and labor policy as well) has risen on the agenda of many emerging market governments and international organizations in recent years largely as a consequence of economic reform and globalization. These policy shifts, with the new risks and heightened sense of economic volatility they have seemingly brought in their wake, have catalyzed the demand for social insurance schemes like unemployment compensation, pensions, and targeted social assistance for the poor. The rapid economic changes that have accompanied reform programs, and

the sudden and severe financial shocks that many countries have experienced in recent years, have caused workers to feel more insecure about their livelihoods and income streams; they have responded by demanding some degree of protection against job displacement, income loss, and unemployment. In the absence of private markets for such protection (and in most developing countries social insurance and assistance have been provided by extended family networks, which may not be able to cope with large systemic shocks), citizens have turned to the state.

But social policy has become relevant not solely because of its potential role in lending a helping hand to a country's most vulnerable citizens. Beyond that, the presence or absence of welfare state programs could have wider repercussions for political and economic stability. As 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, 98). In this conceptualization, social policy becomes a form of political risk insurance.

Yet many developing countries and transition economies confront a variety of special challenges in designing and implementing effective and efficient social policies. The World Bank reminds us, "The state may well be the best agent to provide insurance, but lack the necessary institutional strength, financial resources, or management capacity." Governments must also face difficult political economy issues in structuring these programs, in that "the political support to allocate resources may also be lacking, since it requires getting the rich to support a program that does not benefit them" (World Bank 2001, 150). In sum, the emerging market economies are subject to a particular set of problems in meeting the needs of their unskilled, unemployed, poor, aged, and sick populations.

Despite the enormous literature on economic and political reform in emerging markets, scholars have paid relatively little attention to the role of social insurance and assistance schemes in the sequencing process, paying relatively more attention to policy measures such as macroeconomic stabilization, privatization, or market liberalization and opening (for exceptions, see Graham 1994; Chu and Gupta 1998; Ghai 2000; Institut Français des Relations Internationales 1996). Social policy did not figure prominently in the early iterations of the so-called Washington consensus program of economic reform, in part because of a widespread belief among economists that the "strong medicine" of "good" policy would produce the sort of sustained growth that promoted employment and wealth creation, making many social policies largely unnecessary (Williamson 1994; Rodrik 1996). And in certain regions, especially East Asia, specific cultural values and deep wells of social capital appeared to

make the formation of welfare state institutions irrelevant, if not counter-productive.

Two recent events 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 to 1998 that began in Thailand before launching its global spread to Russia and Brazil. The economic transition, which has plunged millions into poverty and 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 the International Labor Organization’s Eddy Lee, “widespread social distress” (Lee 1998), as unemployment and poverty levels reached heights unseen in recent memory. These shocks, along with the almost daily reminders provided by World Bank officials and other global leaders about the persistence of poverty and inequality around the world, have made policymakers more modest about the prospects for sustained growth in emerging market economies. Following the terrorist attacks of September 11, 2001, Western governments have apparently placed renewed emphasis on foreign aid and economic development. In that context the function of social policy within a broader strategy for reform will likely become central to debates in the Middle East and elsewhere.

This book seeks to contribute to these ongoing discussions of how best to structure social policy in the context of emerging market economies. In so doing, the authors of each chapter have examined in detail the policy experiments and experiences of several major regions over the past decade to see whether any “best practices” have yet emerged and whether the developing world seems to be converging toward some common approaches to policy.

This introductory chapter discusses some of the major themes emerging from this collective project. As will soon become apparent, generalizations are difficult to draw from such a diverse set of regional cases—not surprising when one thinks, for example, of the widely differing demographic trends around the world, from declining populations in Eastern Europe to expanding populations in much of the South—but certain common reference points do exist. Pension reform, for example, is on the policy agenda of almost every nation. The simultaneous treatment of social policy by so many countries suggests the possibility of systemic and not just national influences. Specifically, in this chapter we seek to highlight the role of economic openness—and with it the associated spread of liberal economic ideas and ideology—in catalyzing debate over social policy around the world. In short, social policy has now become part and parcel of the neoliberal economic prescription. Still, the specific policy measures to be adopted engender a degree of controversy that is not

equally present in discussions of most other aspects of economic reform, and this book provides a lens for viewing these ongoing debates.

The Emergence of Social Policy

Although most developing countries offer at least some type of social insurance to particular groups of citizens (for example, pensions to public sector employees), there is tremendous variation in both the quantity and quality of welfare state services. In many cases, social policy is largely notable by its absence. As the World Bank states, "In practice, there are almost no insurance markets in developing countries because of problems of contract enforcement and asymmetric information. People . . . have to rely largely on self-insurance and informal insurance instead" (World Bank 2001, 143).

What factors might be leading the governments of emerging market economies to play a more decisive role in the design and implementation of social policy? In searching for answers to this question, we may find some clues in the history of welfare state institutions in Western Europe and North America. But that history continues to be debated by scholars, and no durable consensus about the formation of social policy has yet been forged. Some scholars point mainly to economic factors, including industrialization, urbanization, and unionization. Others point to distinctly political factors, including democratization or the rise of socialist parties. Still others look to contingent, historical factors, including the experience of wars and the state's need for a healthy body of worker-soldiers (for literature reviews, see Esping-Andersen 1990; Kapstein 1999). And some, like Peter Lindert, believe that no universal cause suffices or even necessarily predominates; as he writes in his contribution to this volume, democracy, demography, income growth, and the changing self-interests of different franchised groups have determined the share of social spending in the economy. Lindert also highlights the independent role of ideas in shaping policy change, a theme we return to later in this chapter.

Reflecting Lindert's diverse list of factors, each of our authors tends to favor certain explanations over others in tracing contemporary policy developments, reflecting the peculiarities of the countries and regions they have studied. The chapters by Barr on Central and Eastern Europe and by Tzannatos and Kaur on the Middle East and North Africa tend to focus on economics and demographics in explaining the social policies that have emerged. Birdsall and Haggard, in contrast, highlight the role of democracy in promoting East Asian social policies. This reminds us that country- or region-specific influences must certainly loom large in our story. We argue, however, that global forces are now playing an increasingly important role in shaping social policy as well.

A quick look at each of our regional studies points to the limits of any parsimonious account of such a complex phenomenon as the development of social policy. The democracy variable, for example, is problematic in that many of the welfare programs with which we are concerned in this volume reached their heyday not under democratic but rather under communist regimes; still others, for example in many Middle Eastern and North African countries, were developed under monarchic and autocratic rulers. Indeed, communist governments provided their citizens with total welfare: every aspect of an individual's well-being—his or her employment, education, housing, health care, and pension—was provided by the state. And in Western Europe 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 periods following the two world wars (Kapstein 1999).

Nonetheless, a growing body of political economy literature, some of which is reviewed by Lindert, hypothesizes that democracies are more likely to promote welfare state institutions; Birdsall and Haggard also make this argument in their analysis of the East Asian case. One reason 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 a possible downturn in fortune. In the absence of private insurance markets for unemployment, pensions, health care, and so forth, this voter will seek to develop public sector programs by taxing the rich. A related theory focuses on the role of organized interest groups, such as labor unions, 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 markets democratize, political pressures will arise for the further development of social insurance programs.

As these comments suggest, most political analyses of social policy emphasize the role of *national* actors and institutions. Less attention is paid to international political and economic pressures. This represents an important gap in the literature, and it is one that we address in the final sections of this chapter.

If political forces do not provide an adequate explanation for the emergence and growth of the welfare state, what other factors might be responsible? An alternative is to look mainly at the economic changes associated with modernization. Industrialization and urbanization, for example, may spur the creation and growth of social insurance. As these processes unfold, workers leave behind the family networks that previously maintained them during hard times, and in their absence, the state provides this system of support; in so doing, the government acts on behalf of the modernization process. These economic factors, when combined with

growing political contestation, have played an important role in the evolution of the European welfare state; they have been less influential in shaping the East Asian social contract.

Rising incomes may also create greater demand for social insurance. In this model, social policy may be conceptualized as a luxury good that people buy—up to a point—as they become wealthier. Lindert also provides some support for these arguments, noting that the richer the country, the more it tends to spend on social insurance. Further, he observes that public sector social spending is a fairly recent phenomenon, beginning from a relatively feeble base in the nineteenth century and growing particularly rapidly after the end of World War II.

Demographics have also been featured as a driving force behind the welfare state. To be sure, the aging of the population, especially in the North, has played a key role in putting social security on policy agendas almost everywhere in recent years. But Lindert reminds us that during the welfare state's first period of growth, from 1880 to 1930, European populations were also aging (as well as democratizing); thus we find Bismarck launching old-age pensions among his social insurance schemes.

Looking beyond Western Europe, Lindert's examination of economic and demographic factors leads him to argue that the post-communist transition economies face a particularly potent mixture as they debate social policy reform. For one thing, their populations are old by world standards, raising the demand for public pensions. For another, their social programs had already begun to decline in the 1980s before collapsing in the 1990s due to their economic problems and the huge increase in poverty, unemployment, and inequality. This double bind makes pension reform one of the most pressing problems that these countries must grapple with, on top of all the other overwhelming economic and environmental tasks they confront.

In his chapter on Central and Eastern Europe, Barr agrees with this gloomy assessment. The old system of pensions, he argues, "is ill adapted in several ways to the needs of a market economy." Under communism, the retirement age was low, and numerous special schemes existed for workers in sectors such as coal mining or in particularly harsh regions such as northern Siberia. As a result, by the 1990s, pensions were claiming a double-digit share of public spending.

Barr then lays out the various options for lessening the pension burden and reforming the system. He reminds readers that each of these options—for example, privatization of pension schemes—is fraught with political (and economic) consequences and risks creating a backlash against the larger reform process; again, we are reminded that one argument for social safety nets is to mitigate the harsh effects of liberalization. Barr posits not only that pensioners may vote against economic reform

in the future (and pensioners are a large and growing share of the voting population) but also that workers who want to ensure their future benefits may balk at any proposed changes that could turn them into “losers” in retirement. Incidentally, Barr also provides us with some very strong reasons as to why privatization of pensions is not necessarily the “answer” for reform in Central and Eastern Europe, given the existing set of demographic and economic problems (not to mention regulatory problems in many of these countries, which he does not emphasize). The problem here is that private pension schemes must be regulated by public bodies, which either do not exist or lack public confidence, given corruption and the absence of a sound judicial system.

Barr further highlights the weakness of administrative capacity in the transition economies for dealing with the profound economic changes encountered after 1989. The rise in poverty and unemployment led to a widespread demand for income transfers, but basic questions about who should receive these transfers and how much should be paid—again, in light of tremendous fiscal stringency—loomed large. As his data show, they were never successfully resolved. Social policy officials simply lacked the appropriate mechanisms for targeting and reaching those who were hardest hit by the transition. The results have been particularly harsh for women and children.

In several important respects, the social policy challenges facing the countries of the Middle East and North Africa are not altogether different from those facing the countries of Central and Eastern Europe. Like the transition economies, these countries entered the 1990s with a large public sector, one that had swelled in large measure due to the oil revenues of earlier decades. Although the public sector was in many, if not most, instances woefully inefficient, it was remarkably successful in delivering a wide variety of social services to its population. By the 1990s, according to Tzannatos and Kaur, the MENA region had “the lowest poverty rates in the developing world.” Other indicators were equally impressive: universal education was now “within reach” and “over 90 percent of the population had access to health services,” with sharp declines in infant mortality and morbidity rates.

But as the region entered the millennium, these gains appeared tenuous in light of growing political conflict and rising pressures for economic reform (although the sharp increase in oil prices in 2000 may mitigate at least the short-term fiscal pressures in several countries). Indeed, the reforms made to date have been accompanied by profound social dislocation, especially rising unemployment, providing fuel for radical groups. In the past, employment depended heavily on the state sector, and with growing state interest in the revenues associated with privatization, alternative sources of work must be found. Unfortunately, the new jobs

have yet to materialize, and the MENA countries have entered the millennium with rising urban unemployment and the threat of radical uprisings.

Beyond the aggregate levels of unemployment evident in many parts of the developing world—and for many years labor economists basically dismissed the presence of unemployment in most emerging market economies, given their largely rural structure—privatization has also brought labor market mismatches into sharp relief. This also has occurred in the transition economies. The set of skills needed to function successfully in the market economy is not necessarily the same as that necessary for surviving in a state-owned enterprise and state-dominated economy, compounding the employment problem. Human capital formation has thus become a key issue for the governments of Middle East and North Africa, although Tzannatos and Kaur doubt that active labor market policies will have much effect on the overall employment rate. The number of jobless will only be reduced as the conditions for sustained economic growth are established.

Like many other parts of the world, the region is also grappling with aging populations and poorly designed pension schemes. Tzannatos and Kaur report that “pension finances are deteriorating” both for demographic reasons and because governments have used surpluses from the pension funds in the past to finance inefficient projects, leaving these funds seriously depleted. The authors emphasize that privatization revenues will not be sufficient to take care of all the gaps and problems in social funding that currently exist.

Tzannatos and Kaur argue that MENA governments must introduce private social insurance schemes and thus competition into the market if they are to meet the population’s growing need for services. That naturally implies a changing role for the state, in which its functions will go beyond social service provision to social insurance regulation. Yet, as we have seen with respect to the transition economies, and indeed most other developing countries, establishing regulatory institutions that win public trust is no easy matter. Corruption, a lack of efficient and effective judicial systems, and simple incompetence make it difficult for ordinary citizens to put their faith in the government; as a consequence, economic activity goes underground. In MENA, as elsewhere in the developing world, the informal sector is a significant generator of employment, but not of tax revenue! Perhaps the oil boom of the early twenty-first century, should it continue, will help at least some of the MENA countries to delay making hard choices, but growing pressures on social policy, from an aging population, on the one hand, and joblessness, on the other, will require major changes in the design and delivery of programs.

In both the transition and MENA economies, governments must struggle with the reform of existing social insurance policies, especially public

pension schemes (this is not to minimize other social problems, like poverty, but pension reform is the main budgetary burden that must be lifted). The problem in East Asia, in contrast, is one of fashioning social policies more or less from scratch. As Birdsall and Haggard point out, East Asians had little in the way of social insurance when the financial crisis of 1997 and 1998 swept over them. Instead, social insurance was provided either through enterprises or through family and social networks. More broadly, they write, it was provided indirectly through the promise of sustained and widely shared economic growth.

When that promise was shattered, it led to a sweeping reexamination of the social contract. Birdsall and Haggard show how the World Bank, Asian Development Bank, and International Monetary Fund (among others) urged East Asian governments to develop social safety net programs and Western-style welfare state institutions, and they financed scores of studies and projects aimed in that direction. "The result," they write, "was a proliferation of program initiatives."

But the governments balked at this advice, for several reasons. First, most East Asian states lacked the administrative capacity to carry out widespread social programs. Second, the authors report, "A number of Asian policymakers . . . were wary of the new social agenda because of the potential for leakage not only to the nonpoor . . . but also to local politicians and corruption." Finally, officials were concerned that state-led programs might displace traditional family and social networks that had been responsive to crises in the past; indeed, this social capital is widely viewed as one of East Asia's great strengths.

Birdsall and Haggard also emphasize that, on the demand side, East Asian politics were not organized in such a way as to promote welfare state policies. The political parties and interest groups that had won many social programs in the West during the nineteenth and twentieth centuries (for example, socialist parties and unions) were either weak or nonexistent in many of these countries (with South Korea at least a partial exception to this rule, as labor did have some voice in the deliberations over crisis management). The lack of fully developed democratic institutions dampened the voice of those who were most vulnerable during the economic crisis and prevented them from acting in an organized fashion. In short, history, politics, and culture conspired against the creation of an East Asian welfare state.

What does that portend for the future? Birdsall and Haggard return our attention to the role of democracy in shaping social policy. They conclude, "In the end, democratic politics will be fundamental to shaping a more explicit Asian social contract." And they are optimistic that democratic politics in this region will fashion a more or less inclusive social safety net, in which both poor and middle class receive adequate coverage.

Yet in East Asia, too, demography and economics may quickly overshadow the debate that emerged following the financial crisis, which focused on poverty relief and unemployment insurance. In that region as well, aging populations may place such heavy and unsustainable burdens on family networks that health care and pensions will come to dominate social policy as the first order of business. Combined with a democratic politics that encourages aging voters to organize, this may further skew social insurance priorities. Again, given the lack of history of state-provided pension schemes in the region (except for certain privileged groups), it remains to be seen whether a distinctive Asian model will arise.

As this brief review of our regional chapters suggests, pension policy has emerged as a common theme around the world, in emerging no less than in industrial countries. And in most places, policymakers are at least giving some consideration to pension privatization, meaning a shift from state-sponsored pay-as-you-go systems to schemes in which individuals vest their savings with financial intermediaries in the private sector. How did privatization emerge as a “universal” solution to the pension problem? We treat the globalization of this and other ideas about social policy reform in the following section.

The Role of Liberal Ideas and Ideology

When one observes the changes that have occurred over the past two decades in the role of the state and welfare policy in developing and transition countries, one is struck by the prevalence of policy prescriptions similar to the ones routinely made in the developed Western countries. These include a triad of measures, notably *privatization*, especially of the pension system, *means testing* of social assistance, and *decentralization* of social policy to the regional level. Why have these policy approaches been advocated, by the World Bank and other institutions, as the right ones for both developed countries and emerging market economies? In this section we focus on the spread of ideas, in particular with respect to pension reform.

It was Keynes who stimulated the study of ideas in economic policy, writing in the often-quoted closing paragraph of *The General Theory*, “The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else . . . [T]he power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas. Not, indeed, immediately, but after a certain interval . . . soon or late, it is ideas, not vested interests, which are dangerous for good or evil” (Keynes 1964 [1935], 383).

In our case, we recall that the initial onslaught against the “bloated” welfare state—and against some of the state’s functions that many came to associate with developments following World War II in Western Europe and, albeit to a lesser degree, the United States (although we should remember Lyndon Johnson’s Great Society)—emerged from the rhetoric of Margaret Thatcher in Great Britain. The same wave washed over to the other side of the Atlantic during the administration of Ronald Reagan and then proceeded to affect the rest of the world.

Most notably for our purposes, the emerging neoliberal rhetoric, with its emphasis on minimal government and “good” economic policy, became transformed for development purposes as the Washington consensus, which had a profound influence on international financial institutions like the International Monetary Fund (IMF), the World Bank, and Inter-American Development Bank. However, the Washington consensus gave social policy short shrift, and its only indirect recommendation was that public expenditures be redirected away from defense, general industrial subsidization, and “white elephant” public works programs and toward preventive health care and primary education. When the author of the Washington consensus, John Williamson, revisited his policy list in 1997, he added targeted antipoverty policies to the list of expenditures that need to be expanded (Williamson 1997).

The international financial institutions do not work, of course, in a vacuum; rather they reflect the dominant ideological atmosphere of their member states. Following the eruption of the Latin American debt crisis after 1982 (which, of course, encompassed Poland, among other non-Latin American countries), these institutions had an opportunity to spread the gospel of the minimalist state through the doctrine of structural adjustment. This doctrine became the heart and soul of post-1982 conditionality programs, emphasizing budgetary restraint, fiscal discipline, the privatization of state enterprise, and economic openness; it profoundly influenced economic policies first in the South and, after the end of the cold war, in the East (on the role of international financial institutions in transition economies, see Deacon, Hulse, and Stubbs 1997).

The policy recommendations made by the financial institutions generally followed the cookie-cutter or one-size-fits-all approach. This was particularly the case after the regime changes in Eastern Europe, in large part because the knowledge base of the World Bank and International Monetary Fund with respect to these economies was limited both in space (only Yugoslavia, Hungary, and Poland were members of these organizations) and in scope (for example, the entire work program of formerly socialist economies focused on macroeconomic issues and the productive sectors).¹ Of course, even if their knowledge had gone deeper, their priorities

and policies would naturally have reflected the ideological preferences and predilections of the dominant member states.

The social sphere recommendations that followed in the early days of transition were often criticized for being out of touch with these countries' reality and history. For example, one of Hungary's most eminent social scientists, Zsuzsa Ferge, argued that the World Bank was oblivious to Central European history and culture, which, in ethnically homogeneous societies like Hungary's, stressed the need for social solidarity (much the same could be said about the East Asian case). The reform measures being contemplated, with the likely increase in poverty and income inequality, might tear that solidarity asunder. Some Central European countries were upset at being given the same recommendations as Kyrgyzstan and Uzbekistan. A Bulgarian economist writes, "When I read what the IMF, the World Bank, and other international financial institutions say about Bulgaria, I always ask myself a question: is it the same country where I live and which I see with my own eyes of a citizen and a professional? The true Bulgaria is very, very different from the one presented by the IMF and to a lesser degree by the World Bank publications. And this is particularly true for the social dimensions of transformation."²

But in addition to the ideological changes that were exported to emerging markets from outside, at least one important influence came from within the group of developing nations. Moreover, that important example would ultimately influence economists and policymakers working inside the very institutions responsible for exporting policy advice. We have in mind the case of Chile in the wake of General Augusto Pinochet's accession to power. The Pinochet regime adopted three approaches to social policy reform that would heavily influence the thinking of international financial institutions and, through them, other emerging markets as well.

First, Chile initially implemented the major social policy change that we have identified in this section—pension privatization. Privatization of the pension system was a watershed event, so much so that the very details of Chilean privatization techniques were copied in other countries or at least influenced their reforms (for example, in Argentina, Kazakhstan, and New Zealand and in a milder version of so-called "notational contributions" in Croatia, Hungary, Italy, Latvia, and Sweden). The chapter by Székely and Fuentes highlights the role of the Chilean pension scheme in influencing developments in Latin America and beyond.

Second, Pinochet's introduction of workfare and public works programs, which at their peak in 1982 employed 13 percent of the labor force, represented, at least for a developing country, a bold innovation, which was later replicated by several other governments, such as that of Argentina (Graham 1991).

Finally, the effort to put into effect improved targeting of social assistance, with the creation of the Ficha poverty index, was later copied in a number of countries, including most recently Armenia and parts of Russia.³

What was so unique about Chile? Chile combined three features that are seldom found together and whose combination made the Chilean experience, at least to development economists, an example to follow. Most prominently, Pinochet's Chile was a right-wing dictatorship devoted, or so it seemed, to maximizing the nation's economic welfare. Unlike many, if not most, dictatorships, this one did not appear to be concerned solely with self-enrichment. Second, the leaders were willing to allow the "Chicago boys," the technocrats, almost free reign in economic matters. The technocrats were not forced to tailor their policies in such a way as to help the rulers amass wealth, on the one hand, or to please the crowd, on the other. Economic policy thus managed to steer clear of the shoals of kleptocracy and populism. Unlike economists advising democratic governments, those in Chile were untrammelled by political parties, trade unions, and parliaments; their decisions were not debated in the political arena. Although development economists might not admit it openly, Chile once represented for many of them the closest one could come, this side of the Hades, to a benign dictatorship (at least alongside Senior Minister Lee Kuan Yew of Singapore) dedicated to maximizing the nation's economic well-being.

The third, and possibly the most unusual, feature of the Chilean regime was that some of the country's neoclassical economists were interested in social issues. Miguel Kast and a number of economists from ODEPLAN, the agency set up to define and implement the new welfare policy, launched an admittedly technocratic, but very important, program of social assistance. The agency's economists designed and implemented targeting of welfare benefits, workfare, and school lunches. The emphasis on the targeting of welfare was not new: it was a key feature of the residual welfare state (as in the United States and Switzerland), but the thoroughness of its application was new for the developing world. No one who has seen ODEPLAN's detailed poverty maps of Chile could remain indifferent or fail to be impressed with the seriousness and thoroughness with which "the fight against poverty" (viewed almost as a disease to be eradicated) was undertaken.

In short, what started in Chile in the mid-1970s as a radical experiment evolved over the next decade to become the orthodox prescription that other developing countries were supposed to adopt. The Chilean model was spread around the world not only by self-promotion and the publicity surrounding its success but also by the leading international financial institutions, which found in Chile the star pupil "bad" students might do well to exemplify. We do not deny the progress that Chile has made along

any number of economic and social indicators since the liberal reforms went into effect (although the Chilean pension plan does not reach all members of society and thus is far from universal), but we do question the wider applicability of many of these reforms in different socioeconomic and political settings, where the government may possess less in the way of fiscal resources or administrative capacity.

The Role of Globalization

If the example of Chile provided an “internal” stimulus for social policy reform within emerging market economies, systemic factors in the form of increasing economic openness were also at play. Increasing openness to flows of trade, finance, and investment held great promise for developing nations but also posed new risks for existing economic arrangements. How these forces played out for social policy remains a topic for debate. There are, to simplify our discussion, two views on how globalization has influenced welfare state institutions. Both have some theoretical merit, although neither has enough empirical support to claim victory in the paradigmatic conflict.

One prominent position, drawn mainly from public finance theory (and, more specifically, from the Thiebout hypothesis), holds that globalization leads to what is called a race to the bottom, whereby countries with more developed (and costly) systems of social protection are forced, due to international competition, to downscale their social transfers in order not to lose potential foreign investment (see Deacon 1998a). Writing in this vein, Benvenisti (1999, 167) claims, “Globalization provides ever-growing opportunities for small groups of producers, employers, and service providers to shop the globe for more amenable jurisdictions. An international ‘race to the bottom,’ spawned by the decreasing exit costs of many businesses, threatens to compromise the achievements of the welfare state.”

Implicit in this view is the worldwide dominance of capital over labor. Capital is mobile, which gives it political and economic leverage over labor and the state. Governments want to attract investors to their countries and are willing to trade workers’ rights (and social protection in general) against the private rents (for politicians and the elite) and national income associated with greater capital flows. The tradeoff between social security and income is, in this view, quite stark, and if market forces were not enough, the IMF and World Bank have supplied further pressures in this direction. Faced with this prisoner’s dilemma—in that each state chooses to compete against others for investment rather than cooperate on reaching some common standards—the individual government goes ahead and implements capital-friendly policies both to keep its own capital at home and to attract funds from abroad, no matter the costs.

A contrasting—one might say more historically oriented—view holds that the maintenance of social cohesion is a *sine qua non* for globalization to proceed (see, for example, Kapstein 1999, 31; Rodrik 1998, 157). Without social cohesion, the electorate (as represented by the so-called median voter) might easily succumb to the temptation of populists and demagogues who espouse protectionist and nationalistic policies directly opposed to international integration. In this view, in order for globalization to be “safe,” it has to be based on the bedrock of social consent, as exemplified by safety net and public insurance programs. Far from being inimical, globalization and social protection are inextricably linked.

If we consider how globalization and the welfare state were related in the past—in order to provide possible lessons for the present—a natural place to start is the “first” era of globalization, which lasted from the second half of the nineteenth century until the outbreak of World War I in 1914.⁴ In the words of Karl Polanyi (1985 [1944], 138–39), this is the period when “nothing less than a self-regulating market on a world scale could ensure the functioning of [capitalism]. The expansion of the market system in the nineteenth century was synonymous with the simultaneous spreading of international free trade, a competitive labor market, and the gold standard: they belonged together.”

This period also coincided with the birth of the modern welfare state. The first, trend-setting, social insurance was introduced in Bismarck’s Germany (health and accident insurance in 1883 to 1884; old-age insurance a few years later).⁵ This was done in reaction to the growth of the socialist movement in Germany, and Bismarck’s decision to ban the Social Democratic party in 1881 was followed by his introduction of social insurance as a way to undercut that party’s popular support by offering workers most of the measures it had advocated.

If we view, as we believe one should, the development of the socialist movement in the second part of the nineteenth century mainly as a response to the “problem” of global capitalism, it then becomes apparent that the extension of the welfare state was *caused* largely by the problems associated with globalization and the insecurities it engendered in the context of the international gold standard. The events of 120 years ago resonate with what we observe today or rather with the dilemmas we face today. This historical analogy thus supports the position of those economists who regard the preservation of the social acquis in the developed countries (and even their expansion) as needed to provide the cushion against which globalization can take place.⁶

How is this to be achieved in poorer, emerging market economies? Even in states with nascent democracies, political voice might be strongly skewed toward those with the greatest economic power, undermining the state’s welfare function. That group, through its financial, social, and

ideational connections with global capital, may form part of a transnational coalition whose interest lies in scaling down the welfare state in industrial countries and minimizing it in the emerging market context. This coalition may be sufficiently strong and well organized politically to achieve that objective, as the experience of the past twenty years could be interpreted to suggest.

Racing to the Bottom or the Top?

Implicit in the race-to-the-bottom hypothesis is a view that all (or most) economies will end up with the same, fairly stripped down, system of social protection. An alternative may be a convergence toward the middle, between the large West European welfare state, on the one hand, and the very lean East Asian model, on the other. Two empirical facts point toward such a development.

First, the differences between the various Western models of capitalism seem to be diminishing. In 1990, when Esping-Andersen published his famous book *The Three Worlds of Welfare Capitalism*, the differences between the universalist (Scandinavian), corporatist (continental European), and residual or liberal (Anglo-Saxon) worlds of welfare capitalism still seemed relatively sharp. The past decade and a half have witnessed the erosion of some welfare state functions in the Scandinavian countries (introduction of private pensions in Sweden and reform of the state pension system in 1998; reform of sickness and unemployment benefits in 1993)⁷ and changes in the corporatist systems (pension reforms in Germany and Italy; sick pay reform in Germany), diluting the corporatist origins of these systems. In a very detailed study of the evolution of European pension systems after World War II, Johnson (1999) documents this growing convergence.

The role of the European Union in stimulating this convergence must be highlighted, both because a single economic space imposes the same requirements on all member countries and because it ensures a better diffusion of information. The importance of differences in national historical trajectories, which shaped the formation of different welfare cultures in early twentieth-century Europe (for example, the role of the Catholic Church, the more or less exalted position of civil servants, differences in the role of trade unions, differences in the strength of socialist and communist movements, and so forth), has much diminished now.

Consider a few examples. The communist movement, which was strong first in Germany, then in Spain, France, and Italy (but never in Northern Europe), is now practically nonexistent in these countries (of course, former communists are in the government in Italy, but they are neither carriers of nor believers in an alternative ideology). The popula-

tion growth rates, which differed between Catholic and Protestant countries, have declined in both and are now lower in Catholic Italy or Spain than in Protestant Scandinavia. The secular role of the Catholic Church has declined with decreasing numbers of regular churchgoers: one needs simply to contrast the role of the Catholic Church in the early twentieth century in, say, Hungary, Portugal, or Spain with its role today. Even Poland, where the importance of the Catholic Church peaked during the communist period, is now reverting toward the European mean.

Second, while the erosion of the OECD welfare state (see Boltho 1997) was occurring in the West, East Asian countries—following dramatic increases in real income—introduced new social programs: for example, unemployment insurance in South Korea and Taiwan in 1998 and 1999. Thus the distance between their welfare states and those in the West has diminished.

Tables 1.1 and 1.2 give a schematic representation of developments in the welfare state over the past twenty years (the shaded cells in table 1.2 represent changes). We can summarize them as follows: the erosion and convergence between the three worlds of Western welfare state; diminishing differences between the Western OECD welfare state and the East Asian countries; the end of the communist welfare state, with formerly socialist countries splintering into two groups: Central European countries joining the Western OECD model and others (particularly in Central Asia and the Balkans) slipping toward developing-country status; and continued or increasing marginalization of many developing countries, especially in Africa.

How far this convergence will go remains unclear. Today, a billion people still live in absolute poverty, most of them unshielded by any social assistance whatsoever. On the ideational plane, governments may be moving toward some convergent views regarding social policy and the welfare state, as exemplified by United Nations agreements, conferences, and speeches. But these governments remain far from turning their social agendas into reality.

The Role of the International Community

What is to be done for those emerging market economies that seek to provide a modicum of social insurance and assistance in the context of a globalizing economy? As we have argued, pressures on these states come from within and without. From within, it is unlikely that those who hold wealth will welcome the redistribution that the welfare state must bring. From without, it is equally unlikely that the global economy will support high levels of social protection in emerging markets. In short, developing countries face a terrible political and economic bind.

Table 1.1 Welfare State Around 1980

Service Provision	Western OECD Countries			Developing Countries
	Communist Countries	East Asian Countries	For civil servants only	
Universal or near universal provision of pensions	Yes; high replacement rates in Eastern Europe, low in the former Soviet Union	For civil servants only	For civil servants only	
Universal or near universal provision of family benefits	Yes in Eastern Europe; not in the former Soviet Union	No	No	
Unemployment insurance	Full employment	No	No	
Socialized health	Yes	Limited	No (in practice)	
Socialized education	Yes	Yes	Yes (limited)	
Score	5	2	1.5	

Source: Authors' compilation.

Note: Family benefits and unemployment insurance in non-Central European, formerly communist countries, formally do not differ from the those in Central Europe. However, their puny amounts, limited coverage, and large arrears make these rights practically irrelevant. For these reasons, Kazakhstan has recently formally abolished unemployment benefits. The same is true for a formally socialized health care, when receiving even a modicum of "free" health care requires that patients bring in their own drugs and food and pay bribes to the doctors. Score was calculated by giving 1 point for each "yes" and 0.5 point for "limited."

Table 1.2 Welfare State Around 2000

Service Provision	Former Communist Countries			Western OECD Countries		East Asian Countries	Developing Countries
	Central Europe	Others	Very low replacement rates	Yes; high replacement rates	For civil servants only		
Universal or near universal provision of pensions	Yes	Very low replacement rates	Very low replacement rates	Yes; high replacement rates	For civil servants only	For civil servants only	For civil servants only
Universal or near universal provision of family benefits	Yes	Limited	Limited	Yes, except in the United States	No	No	No
Unemployment insurance	Yes	No	No	Yes	Limited	No	No
Socialized health	Yes	No	No	Yes, except in the United States	Limited	No (in practice)	No (in practice)
Socialized education	Yes	Limited	Limited	Yes	Yes	Yes	Yes (limited)
Score	5	2	2	5	2.5	1.5	1.5

Source: Authors' compilation.

Note: Family benefits and unemployment insurance in non-Central European, formerly communist countries, formally do not differ from the those in Central Europe. However, their puny amounts, limited coverage, and large arrears make these rights practically irrelevant. For these reasons, Kazakhstan has recently formally abolished unemployment benefits. The same is true for a formally socialized health care, when receiving even a modicum of "free" health care requires that patients bring in their own drugs and food and pay bribes to the doctors. Score was calculated by giving 1 point for each "yes" and 0.5 point for "limited."

As a result, we would argue that international financial and technical assistance can and should play a critical role in promoting investment in social policy development in these economies and that this investment must be targeted at the “losers” from economic and technological change—those who are least advantaged. Indeed, these programs should be part and parcel of international economic policies designed to promote greater opening, and the industrial economies certainly could do much more to open their markets to the exports of developing countries.

The adoption of these recommendations would almost certainly require both an increase in aid funding and a redirection of allocated amounts. Although we recognize the immense political challenges facing both of these developments, we believe that a strong case for this strategy can be made. After all, to the extent that the advanced industrial states are truly committed to promoting globalization around the world, this investment should be seen as a modest contribution to that process.

Clearly, the current spending trend for foreign assistance is not promising. Official development assistance by the major industrial countries reached its postwar high of \$70 billion in 1991. Since that time, it has tumbled to insignificant proportions, largely because of decreased spending by the United States; while the U.S. economy constitutes 30 percent of the industrial world total, its aid contributions represent less than 17 percent of all official flows traveling between North and South. As a result, the member states gathered in the Development Assistance Committee of the OECD recently judged “the current level of American aid as inadequate” (OECD 1998, 1).

Overall, the advanced industrial democracies now allocate less than 0.25 percent of their gross national product to foreign assistance, or 50 percent less than they provided at the outset of the 1990s. It is hard to think of any other program, domestic or international, that has suffered such reductions. The end of the cold war, on the one hand, and renewed fiscal pressure on the welfare state, on the other, have doomed aid budgets everywhere. The ironic result is that this may make it more difficult for emerging market economies to create or reform their own social insurance programs.

To be sure, going forward, aid must be better targeted with respect to both recipients and feasible projects. Aid should be targeted not only at those countries that are committed to economic reform, but more specifically at governments that are also committed to expanding education and work opportunities for the least advantaged. All too often, as the World Bank admits, educational expenditure in developing countries has “not always reached groups that have traditionally had low levels of education (the poor and girls, for instance)” (World Bank 1998, 45).

More broadly, our discussion leads to the conclusion that the World Bank, International Monetary Fund, World Trade Organization, and major bilateral donors ought to reexamine their economic programs and policies in light of the connections between openness and social policy. The received wisdom provides an optimistic view about the evolution of the global economy, teaching that open markets promote efficiency, which produces growth and, ultimately, the wealth needed to finance social programs.

But for reasons of domestic and international politics and economics, that outcome may not pertain. Domestically, the rich may balk at paying taxes that support social programs. And internationally, capital may flee regimes that seek to impose high social charges. Reconciling these internal and external forces in such a way as to meet the vital needs of the developing world's most vulnerable citizens represents one of today's greatest policy challenges. Promoting informed public debate over how those needs can best be met is the main objective of this book.

Notes

1. In the United States, the intelligence community devoted considerable attention to the Warsaw Pact's defense economy and defense industries.
2. Mr. Ivan Angelov in a personal communication to Branko Milanovic.
3. The Fichta assigned different weights to a variety of characteristics (but not income) in order to come up with a cardinal measure of eligibility for various social assistance programs (such as complementary feeding, preschool care, school lunch program, and health care).
4. This is, of course, the same approach used when trying to assess the effect of globalization on a number of other economic indicators (such as international trade, foreign direct investment, and migration). Several recent papers (Baldwin and Martin 1999; Williamson 1996) do this, but none has looked at the relationship between the 1870 to 1914 globalization and welfare state.
5. In terms of redistributive old-age pensions (that is, pensions that, in addition to employer and employee contributions, would include a contribution paid directly by the state), Germany was preceded by Denmark (see Lindert 1992, 11). The Danish example, however, did not have nearly as much influence as the German. It is also interesting that Bismarck strongly argued for state participation in funding, but the proposal was twice turned down by the Reichstag (see Taylor 1955).
6. For example, Rieger (1998), quoted in Deacon (1998b), supports the case that openness in the United States and expansion of welfare spending go hand in hand (although one needs to be mindful of the possibility that both are driven by other variables, in which case the causality between the two may be spurious).

7. The unemployment benefit replacement rate was reduced from 90 to 80 percent, with the first five days of unemployment uncovered; the sickness benefit replacement rate was reduced from between 80 and 90 percent to between 65 and 80 percent; the retirement age was raised from sixty-five to sixty-six years.

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