

# Editorial: Reforming the Welfare State in Postsocialist Societies

JÁNOS KORNAI

*Harvard University, Cambridge, Massachusetts, U.S.A.  
and Collegium Budapest, Hungary*

**Summary.** — The communist system led to a “premature welfare state,” with universal entitlements out of all proportion to the country’s resources and the fiscal capacity of the state. Many citizens suffer heavy losses when the proportions are restored. Great progress has been made with the postsocialist transformation in several fields, but reform of the welfare sector has lagged behind—dominant state ownership, bureaucratic centralization and a lack of competition remain. There are a number of obstacles in the path of reform. Citizens are unclear about the tax burden imposed by state welfare services. Damage can be done by populist politicians, who make irresponsible promises to raise welfare spending while concurrently cutting taxation. Economists have a duty to make a sober appraisal of the situation and present realistic alternatives. © 1997 Elsevier Science Ltd

*Key words* — welfare state, postsocialist transition, communist (socialist) system, pension (social security), system, entitlement, fiscal (public finance) reform

## 1. INTRODUCTION

The transformation that followed the collapse of the communist system has brought great changes in several fields. Institutions of parliamentary democracy have emerged, and produced laws to harmonize with the new system. A legal infrastructure that conforms with the market economy has been installed. The private sector has undergone rapid development, and now accounts for the larger part of production. While these effectual changes have been occurring in other fields, the question of reforming the pension system, medical care and the social assistance programs, or to use the comprehensive concept, of reforming the welfare sector, has been laid aside for several years. A chronic shortage of labor gave way after the change of system to mass unemployment. Although this induced many countries to launch a system of insurance and benefits for the unemployed, other structural changes in the welfare sector have been sporadic and confined to a handful of countries, where they did not begin until recently.

The institutions and organizations of the welfare sector differ from country to country, and in each, a variety of schemes for reform have been proposed. Reasons of space alone would prevent me from

dealing comprehensively with these sets of circumstances and proposals. I will confine myself to identifying a few typical problems, and stating my position on one or two issues.

## 2. AFFORDABILITY

Arguably, there is no aspect of the economy about which the inhabitants of the postsocialist region debate so widely and passionately as the welfare sector. There is bitter criticism from those receiving the services of specific subsectors: old-age pensioners, medical patients, students, or those on welfare allowances. The disquiet is no less among those who provide the services. Doctors and nurses grumble, so do teachers, and officials running the various welfare organizations. Many politicians try to take advantage of this, trimming their political sails to catch the wind of discontent, which sometimes blows up into a storm. An academic researcher has a duty to analyze objectively the factors behind the discontent.

The countries of the post-communist region differ widely in their level of development. They cover a spectrum ranging from severe backwardness (Albania, the post-Soviet republics of Central Asia) to a

medium development level (the Czech Republic, Slovenia, Hungary). Even at the medium level, only a meager standard of pensions, health care and education can be provided, and only bare allowances for those in need. For psychologically understandable reasons, people fail to distinguish, when laying the blame for their feelings of want and their financial problems, between factors explained by the backwardness of their country, by the institutions inherited from the old system, and by the transformation itself.

The dissatisfaction increases when comparisons are made. The nearer a country in the postsocialist region lies to the West, the commoner it is for members of the public to compare their position with those of Western or Southern Europeans, or even Americans, and bitterly note the contrast.

There is another measure of comparison as well—between promises and implementation, expectations and experience. The communist system in the Soviet Union and the Eastern European countries, especially in its latter stages, introduced a widening sphere of universal entitlements. Take Hungary, for example. Every citizen and every family member had a right, free of charge, to health care, sickness benefit, education, tuition and livelihood grants if admitted to university, maternity and childcare allowances, old-age pensions, and so on. Although the standard of these services was not laid down in the constitution or by law, the legal entitlement aroused high quality expectations in people's minds. The mounting economic difficulties under the communist system widened the gap between the expectations generated by the universal entitlement and the degree to which they could be met.

The change of political system enhanced, rather than reduced the unrealistic expectations. Many people hoped that a market economy would increase efficiency and the goods supply at last, and the new democratic state redeem the welfare promises made and broken by the communist state.

In fact, the more a state tries to invest the paper promises with some real content, the heavier the load of taxation it has to impose on the country. Let us examine the implications of a simple calculation. Take an Eastern European country whose per capita GDP is one third of the Scandinavian figure. The country established free university education as a legal principle many decades ago, although the proportion of young people attending university remains far smaller than it is in Sweden. For a country to comply with its promise in full, it would have to fling open the gates of its universities, multiply their capacity, sharply raise the salaries of their teaching staff (if for no other reason, to stem the brain drain), modernize their laboratories and lecture halls, and so on. Fulfilling the pledges in other subsectors will make similar demands. The welfare state imposes a serious budgetary burden even in the

Scandinavian countries, which have started to cut some of the spending. Fulfillment of similar promises is not simply a problem for the far poorer Eastern European and post-Soviet countries, it is a burden they are unable to bear.

Economists, and indeed all responsible citizens who think carefully about it, can see that the welfare commitments a state undertakes must be proportionate to the country's level of economic development. Several communist countries ignored this obvious criterion—affordability—which led to a "premature welfare state". The task for the reform is to devise legal obligations and entitlements in line with the actual resources of the economy and the state's ability to collect tax. Restoring the proportions and revising the excessive promises is a painful process that causes many people tangible financial losses and deprives them of earlier entitlements.

In Eastern European countries where the democratic, constitutional system has consolidated, any reduction in public spending has to go through a cumbersome, lengthy legislative process. (I will return to this later.) For my part I consider that this legal, legislative alternative is the only permissible course. For there is also a brutal way of maintaining fiscal equilibrium. The state simply fails to meet its legal obligations, going for several months without paying its public officials, including those working in the welfare sector, or its pensioners. This has happened at certain times in Russia and Ukraine, for instance. Such a crude imposition of the affordability principle is inhumane, unlawful, and diametrically opposed to the civilized behavior of a democratic, constitutional state.

### 3. INSTITUTIONS AND INCENTIVES

Let us consider some of the features of the communist economic system:

—State and quasi-state ownership predominate almost to the exclusion of other forms of ownership, which hardly play any role.

—Management and coordination are strongly centralized. The political leaders impose their will through a hierarchical bureaucracy. Individual freedom of choice is limited.

—Production is highly concentrated, taking place in a small number of organizations.

—There is a chronic shortage economy. This alone precludes any competition among producers. At most there is competition among buyers for the favors of the producers/sellers. This places the consumers at the producers' mercy.

—There is an extensive system of budgetary subsidization. The subsidies make many products and services very cheap, or even free of charge.

This distorted price system rules out rational economic calculations and incentives.

The radical institutional reforms that have occurred since the change of system have caused profound changes, so that none of these listed characteristics pertains any more in the narrowly defined "economic" sphere. They still apply in the welfare sector, however, where most countries retain unchanged the institutional *status quo* inherited from the communist system eight or nine years ago.

Only in isolated cases have non-state organizations grown up alongside the state institutions. The law has not even become impartial between ownership forms, let alone provided for affirmative action in favor of non-state initiatives. The hierarchical bureaucracy of the state wields an enormous predominance of power. Competition has hardly developed. Health care, higher education and many other services in the welfare sectors still display the familiar features of a shortage economy: queuing, long waiting times, customer-initiated corruption, forced substitution that undermines quality, and so on.

The ownership forms, tax regulations, and written and unwritten contracts among the participants engender a variety of distorted, damaging incentives. Individuals run little risk if they break tax laws. More frequently still, people find loopholes in the law rather than breaking it, and avoid contributing to the public purse, altogether or in part, while continuing to enjoy the benefits of the premature welfare state. I am not speaking here of the poor, who are dependent on social support. Many people from strata able to support themselves and pay their share of the tax burden contribute in taxes and contributions only a fraction of what they receive from the state in pensions, health care and education. The principle of fair and proportionate taxation is not broken simply in terms of rich versus poor. The biggest (though still relatively submerged) conflict is between those who pay high taxes and those who manage to avoid doing so. There cannot be welfare reform without a profound, considered reform of taxation, and vice versa.

#### 4. IMPERFECT AND INACCURATE KNOWLEDGE

The reforms are impeded because many people are ill-informed. For decades they had an ideology of paternalism drummed into them by the communist system. Welfare services were seen as something the state "gives" and the public takes, free of charge. It was to be left to the policymakers to decide how much to give and in what form, as they thought fit, guided by a sense of public service. Relatively few members of postsocialist societies appreciate that the

public has to pay for every burden placed on the welfare state. Knowledge about the quantitative scales is especially deficient. Most people have false notions about the total cost of specific state programs and the burden they place on each taxpayer.

The lack of information and long seclusion from the Western world have left most citizens of postsocialist countries unclear about what alternative institutions can be considered when the inherited welfare system is reformed. The advocates of the *status quo* (who include leading functionaries in the welfare bureaucracy, with reasons of power and prestige for wishing to conserve the inherited system) imply that the choice is restricted to two extremes. One is for the service and insurance monopoly to remain in the hands of a benevolent, paternalist state that cares for all alike. The other is for citizens to be left to their own devices, without communal support, at the whim of an unregulated market economy and a "Wild East" brand of capitalism. When they are sick, they will have to pay all the costs out of their own pocket or perish. When they are old, they will have no pension, unless they have managed to save something for themselves, and so on. In fact there exist plenty of intermediate forms. Private services and private insurers can operate under a legally controlled framework with state supervision. There are non-profit institutions. The state, in many spheres, can provide incentives or counter incentives through taxation and exemptions. Meanwhile the welfare sector as a whole can operate as a composite configuration of state and non-state, bureaucratic and non-bureaucratic, market-regulated organizations, with a wide variety of forms. This is not a choice between two extremes. The goal can be to build up complex, "multi-pillar" constructions out of elements that complement one another.

#### 5. POLITICAL CHOICE AND PERSONAL DECISION

Where does the choice between alternatives occur? One place is the political arena. The firmer a country's democracy becomes, the greater the extent to which every stage in reforming the welfare state is decided by the parliamentary process. On the one hand, this is a big advantage for the reform. The legislature is unlikely to support measures that most of the public would oppose, for fear of electoral consequences. On the other, there are drawbacks to abiding by the democratic rules. Winning parliamentary approval takes time; the process may be protracted. If the circumstances are unfavorable, the search for a consensus may be fruitless, leading to a political impasse.

A greater danger still is that a populist demagogy

may intervene. The welfare sector is the subject on which electioneering speakers are most prone to promise the impossible: tax cuts coupled with a rise in welfare spending. The more irresponsible the promises made, the more attractive they become to inexperienced or ill-informed voters.

This is an almost inescapable side-effect of the salutary influence of political democracy. Economists and experts on social policy have a moral responsibility to refute such demagoguery. Conflicting opinions can obviously be found even in these narrower professional circles. Some support a stronger role for the state and some a weaker. Some recommend higher state welfare spending and some lower. But every scrupulous adviser or expert has to agree on rejecting the promises that cannot be fulfilled.

There is one more lesson to be learned from the frictions and conflicts that inevitably arise in politics.

It is expedient to take the changes in a direction that moves many choice problems from the political sphere to the decision-making province of citizens, the users of the welfare services. As far as possible, let citizens have a direct choice between various pension schemes. Let them decide whom to trust with providing their pension: the state, decentralized pension funds, or other institutions. Let parents decide whether to send their children to a state or a non-state school. Let patients choose between a state or a non-state hospital or medical practice. The state has the task of providing the legislative frameworks for the changes, developing appropriate monitoring systems, and rushing to citizens' aid if they are in need of it. One goal in reforming the welfare system, after decades of spoon-feeding and subservience to political whims, must be to bestow greater sovereignty on citizens.