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THE IMPORTANCE OF SOCIAL INVESTMENTS FOR ECONOMIC GROWTH AND GOVERNANCE IN TRANSITIONING STATES

SURVEY OF RECENT EVIDENCE

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I. INTRODUCTION

Policymakers have to be concerned with the performance of a wide variety of spheres and sectors – agriculture, finance, transport, macroeconomics. At the outset of the transition of the countries in the Europe and Eurasia region, there was wide consensus that the most critical arenas pertained to the control of nuclear armaments, the privatization of property, and the creation of equity markets. Also deeply important were the adjustments necessary for industry, agriculture, mining, and petroleum sectors so that they might become competitive with international suppliers in quality and price. The role of health, education and social policy more generally were considered to be less critical. In part, their lower priority was a function of the belief that governments, under the party/state systems, had done a reasonable job in these spheres. All had attained universal educational enrollment; medical treatment was universal and free of private cost; housing was, at least in theory, available to all.

But over the last decade and a half since the outset of the transition, there was a rethinking about the determinants of economic, democratic, and social performance. Social policy under a central planning model contained critical problems, unique to development economics, and hence not widely recognized at the outset. The social sectors in the Europe and Eurasia region required 'build-down solutions' rather than 'build up solutions.' Development in Asia, Africa and Latin America often required schools and medical facilities to be created where none existed. Europe and Eurasia had the opposite challenge: to restructure the facilities and systems which already existed. Throughout the region the challenge was to adjust social policies and make them efficient, creative, and effective under the conditions of a market democracy. How have the countries done with respect to these challenges? To what extent have newly designed social policies contributed to economic performance and strengthened democracy? What priority should social policy occupy in the elaboration of economic and social advice for the future? This report is written for those who are interested in the answers to these questions.

The purpose of this report is to review the literature on economic growth, governance, democracy, and social policies/investments and to examine the relationship (correlation and when possible, causality) between different types of social investments (such as education, health, social insurance and social transfers), economic growth, and transition to and maintenance of democratic systems in the transitioning countries in Europe and Eurasia. While the primary focus of this review is to examine the impact/relationship of social policies on economic growth and democratization in the E&E region (transition economies), the literature review draws on a much broader body of work from around the world and compares the results/conclusions of these studies with those available for the E&E countries. In that respect, the review aims to determine (or at least note) to what extent the on-going transition process and a relatively short time span may have produced atypical results in the E&E region. Likewise, what lessons can be drawn from the broader world experience that may be applied to the longer-term economic and democratic development objectives in E&E.

In many cases, the data are scattershot rather than representing a comprehensive, holistic review of country performance since most of the studies refer to a single country or compare a few countries. The few available multinational, longitudinal studies that included the E&E countries are highlighted.

The findings from this review of the literature on social policy, economic development and governance imply that **reforms in social systems, matched with increased investments in human capital, will yield a wide variety of benefits to transition countries.** These benefits include:

- Short and long term economic benefits, such as higher worker productivity and increased educational and employment opportunities for disadvantaged groups;
- Improvements in governance, including fiscal discipline with different kinds of long and short term cost savings in public expenditures;
- Reforms of social cash transfer systems and social protection systems which, when appropriately implemented, can lead to improvements in administrative capacity and civil society, thus strengthening democratic development.

Investments in social systems can lower the intensity of distributional conflicts that inevitably occur in politics and reinforce the institutional basis that is necessary for long term economic growth and democratic consolidation. The review of literature in these areas suggests that social investments and reforms improve economic growth and governance while ***indirectly*** contributing to the survival of democratic regimes in the long run. The exact mechanisms whereby social systems influence democratic stability and economic growth are not fully understood.

The discussion is grouped according to three categories: (1) economic development and democracy; (2) social sector investments and economic development; and (3) social sector investments and governance.

II. ECONOMIC DEVELOPMENT AND DEMOCRACY

The most important factor influencing regime transitions and democratic survival is economic growth and development. There is strong agreement among researchers that improvements in average per capita income increase the probabilities of democracy and democratic survival. This suggests that economic development is good for the long term health of democracies. In addition to this, recent empirical results provide some, although less certain, evidence suggesting that economic growth increases the likelihood of non-democracies transitioning to democracy. ***To the degree that social investments influence income, they may indeed have an influence on the progress or regress of democratic regimes***. The influence of social systems on democratic consolidation, therefore, occurs indirectly, mostly through economic growth. The studies conclude the following:

- Londregan and Poole analyzed data from one-hundred countries with an average of twenty-eight observations per country during a thirty-four year period beginning in 1952, they find **higher incomes are associated with greater degrees of democracy**. They argue the effect is small but robust even after controlling for a wide range of effects associated with economic development.

- Przeworski et al. (2000) investigated whether economic development is conducive to political democracy. The sample included 141 countries from 1950 to 1990, excluding all Europe and Eurasia countries. This study finds that **economic development, measured by per capita GDP, is strongly correlated with transition to democracy and transition from democracy to authoritarianism**. They conclude that democracies are much more likely to develop and endure in more highly developed economies, and that economic growth contributes to the survival of democracies under varying levels of economic development.

- Using Freedom House measures for democracy, Barro (1999) shows in a cross-country panel study using six observations for each country during the period 1972 to 1995, that **increases in living standards (measured in several ways including per capita GDP) forecast a gradual rise in democracy**.

- Boix and Stokes' study (2003) shows that the probability of a democratic breakdown declines with increases in per capita income and also that the stability of authoritarianism also declines with increasing per capita income. Boix and Stokes show that **the probability of democratic breakdown declines steeply with income, while the probability of a transition to democracy at any given year increases moderately with increasing income**. They claim this substantiates the view that economic development increases the probability of a transition to democracy.

- Epstein et al. (2004) use a more refined measure of governance that includes transitioning states. Using data from 1950 to 2000, this study classifies regimes into three types: autocracies, partial democracies and democracies. They find that **average per capita GDP is a significant predictor of good governance for all regime types, although higher levels of income are most important for democracies**. In their view, increasing economic development (a) increases the probability of transitions from autocracy or partial democracy to democracy, and (b) decreasing or low economic development increases the probability of backsliding from democracy into partial democracies.

The research cited above demonstrates convincingly that economic growth is related to, in some cases causally, democracy and democratic survival.

A. Empirical Evidence on Economic Voting and Voter Backlash

While the evidence presented above might lead one to believe that voters in shifting, unstable economies might elect less democratic candidates if they promise greater economic support from the state, **national election studies and survey research do not demonstrate a consistent link between a person's current income and voting for or against parties that support greater provision of social assistance in transition states**. Cross-national election studies and case studies do, however, show strong and consistent linkages between assessments of the economy and voting behavior. However, these assessments are frequently conditioned by a voter's ideological or partisan preferences. Voters in the transitioning countries express strong support for redistributive social policies. However, the poorest voters do not consistently vote for parties that support greater social assistance provision in transitioning states.

- In one of the most comprehensive investigations of economic voting behaviors Tucker (2004) finds support for a 'partisan effects' model of economic voting. Tucker investigates 20 national elections across five transitioning countries from 1990 until 1999. He finds that **parties associated with reforms benefit from stronger economic conditions while parties associated with prior communist regimes benefit from weaker economic conditions**.

- In a careful study of voting in Poland from 1990 to 1995, Bell (1998) finds that **unemployment rates are strongly related to voting behavior for left candidates and parties**. This study is one of the few studies that directly support pocketbook voting.

- In a series of studies on voting in Russia, Konitzer-Smirnov (2003a, 2003b, 2005) found that **voters punished incumbents for overall performance in the economy**. Furthermore, this behavior translated into election outcomes for the set of regional executive contests that occurred in Russia between 1996 and 2000. Therefore, not only did voters make decisions to vote against incumbents whose regions performed worse than others but, despite the obstacles of deep media bias, election laws and other features of electoral institutions that favored incumbents, these individual decisions manifested themselves in actual election outcomes.

The research cited above indicates that voters are more likely to vote on the perceived overall economic environment rather than individual circumstances. But economic growth, through employment and increases in household income clearly matters to voters.

B. Income and Wealth Inequality and Economic Development

There are several theories about the relationship between income and wealth inequality and economic development. According to Kuznets hypothesis (1955), increases in income or wealth inequality are expected during early stages of economic growth, especially when production transforms from rural to urban and from agricultural to industrial. Higher inequality is expected because in the process of development, economic growth modifies the distribution of resources and rewards across sectors. As production increases and converges to the level of more developed economies, inequality in the distribution of resources diminishes and per capita GDP increases. **The picture drawn from the recent empirical analyses of the Kuznets hypothesis varies across countries, regions, and time**.

Three studies with consistent data sources and consistent statistical methodologies found that income or wealth inequality is negatively associated with growth.

- Using average annual rates of per capita GDP growth over the 1960 to 1985 period, Alesina and Rodrik (1994) regressed growth on the Gini coefficients for income inequality and land distribution inequality beginning in 1960. Both **income and wealth inequality had significant negative impacts on growth**.
- Persson and Tabellini (1994) regressed growth over the same period on the income share of the middle class as their proxy for wealth equality. They found that **income inequality reduced growth**; the larger the share of income going to the middle class, the less income inequality in the country, and the higher the rate of economic growth.
- Perotti (1996) found similar results for a larger cross-section of 67 countries for the period 1960 to 1985 – **income inequality** (measured by Gini coefficient and the income share of the third and fourth income quintiles) **reduced economic growth**.

Several studies reported less certain conclusions about the relationship between inequality and economic growth, but the results are sensitive to how inequality is measured or the sample under consideration. Several studies found wealth inequality, but not income inequality, to be an important factor in economic growth:

- Deininger and Squire (1998) found no significant correlation between growth and income inequality. Yet they did find that that **high inequality in the distribution of land had a significant negative influence on growth**.
- Birdsall and Londono (1997) also found **a strong relationship between growth and initial distribution of assets (such as land or human capital)**; however, once this was accounted for, variations in income inequality did not seem to affect growth.
- Barro (2000a), using statistical techniques that employ five-year time series, found no relationship between income inequality and growth rates. However, he found **a positive relationship between inequality and growth in richer countries and a negative relationship between inequality and growth in poorer countries**; the pattern supported the Kuznets hypothesis described at the beginning of this section.

Inequality and Economic Development in E&E Countries

The studies cited above on inequality and growth evaluated data on countries outside the Europe and Eurasia region or used data from the region prior to 1990. For the E&E region, Keane and Prasad (2002a) examined the change in income inequality in Poland after the 1989 reforms. They found a large increase in inequality in earnings following the reform but no increase inequality in income or consumption. The increase in earnings inequality was offset by the increase in pension payments and other social transfers. They were not able to measure the effect of the change in inequality on economic growth in Poland, but they tried to draw some conclusions about this relationship from growth models for 14 E&E countries during the 1990s. They analyzed changes in inequality as measured by the Gini coefficient along with initial conditions at the start of transition and the pace of reforms in each country and their relationships to per capita GDP growth. They found that **inequality was negatively related to GDP growth while market liberalization was positively related to GDP growth**.

The conclusion from the world-wide literature on growth and inequality is mixed. For countries outside of the transitioning region, there is no consistent evidence that inequality has a significant impact on economic growth. In a few specific studies there is evidence of a positive relationship, but inequality is not as important to growth as physical and human capital change. For the E&E region, the literature on growth and inequality is thin and, in this review, limited to one study. Without more research on the growth-inequality relationship in the E&E region, the size and robustness of the benefits from redistributive policies for growth are still uncertain.

C. Income and Wealth Inequality and Democracy

Available studies show no systematic responses by citizens in transitioning states, when ruling parties do not reform social welfare systems or do not invest in improvements in social systems. **Studies of regime transitions, however, provide evidence suggesting that increasing inequality (which is often redressed through social investments) is associated with less democratic stability, making backsliding more likely as income or wealth inequality increases.** While these studies measure inequality in very different ways, making comparisons more difficult, the findings are still relevant.

- Boix (2003) and Boix and Stokes (2003) provide strong support for the claim that **inequality is bad for democratic survival**. Employing a combination of measures to estimate wealth inequality, including the distribution of agricultural property, the quality of human capital and the Gini Index, they show that **economic equality increases the chances of transition from autocracy to democracy and also increases the stability of democratic regimes**.

- Epstein et al. (2004) show that **inequality is more likely to contribute to the stability of autocratic regimes, while making democratic regimes less stable and more likely to backslide into partial democracies**.

- Przworski et al. (2000) also provide partial evidence (based on a limited sample) showing that **income inequality in democracies** (those with Gini coefficients greater than 0.35) **leads to greater chances of backsliding to authoritarian rule**. The same authors provide evidence showing that several other measures of inequality, including wealth inequality, are also associated with decreased democratic stability.

III. SOCIAL SECTOR INVESTMENTS AND ECONOMIC DEVELOPMENT

This section reviews the findings of studies on education, health, active labor market programs, and social transfers on economic development. Overall, **redistributive social investments are not inconsistent with long term growth**. Social systems can influence economic performance in transitioning states through the targeted or means-tested redistributive policies. Cross-country studies show that redistributive taxes supporting spending on the poor, elderly, and other disadvantaged groups are positively related to GDP growth. One regional study shows that higher levels of social spending also are positively related to GDP levels in transitioning states. These studies suggest that redistributive social investments promote long term economic growth.

A. Education and Economic Development

Most research in countries outside the E&E region suggests that educational attainment is an important factor in economic growth. Educational investments that permit access to quality primary and secondary schooling for all income groups are likely to be an important ingredient for long term economic growth. Recent research also finds that university education is of importance to technological diffusion and innovation which are essential to economic growth. These results suggest that insufficient investment in education may depress long term growth even if economic and labor market reforms are successfully implemented.

- **Education contributes to economic growth through increased per capita earnings (private returns) and social returns**. Studies of earnings or income at the individual or household level consistently show the economic benefits to education investment in countries at all levels of development. These results are expected to translate into important effects of education for growth and aggregate income.

- **The primary direction of causality, according to one study, is from growth to schooling, not from schooling to growth** (Bils and Klenow, 2000). The study concluded that the demand for schooling increased with economic growth and responded strongly to the return to education investment.

- **The link between growth and returns to various levels of education varies as a result of different levels of economic development** (Petrakis and Stamatakis, 2002). In less developed countries, primary and secondary schooling are more important, while higher education is more important in OECD countries. As the level of development increases, so does the value of higher education.

- **Almost all of the studies reviewed found a positive correlation between school enrollment and economic growth**. One study of 98 countries from 1960 to 1985 period found that the enrollment rate for those aged 15 to 17 had a positive effect on growth. Another found that the primary enrollment rate was positively related to growth. Yet another evaluated growth across 118 countries and found that male education increased growth.

- **The contribution of additional years of schooling to aggregate economic output varies enormously across countries, depending on many different country conditions.** Local country conditions that influence the quality and flexibility of labor markets impact how efficiently skilled labor is used. These country specific factors condition the importance of specific human capital investments for economic growth.

- **High quality and relevant curricula support economic growth.** Results on standardized international tests, such as the International Adult Literacy Survey and the Third International Mathematics and Science Study, were used as a proxy for quality of education. Regardless of the average years of education completed in the country, **countries performing well on international standardized tests also grew faster** (Barro, 2002).

- **The return to education is highest in the lowest income countries.** Each additional year of education increases earnings by 10 percent on average. Private returns to primary education are larger than returns to secondary education, and private returns to secondary education are larger than returns to higher education.

- **Social returns to education are lower than private returns** because of the large education subsidies received by individuals and the inability to adequately measure the social benefits from education (for example, higher formal sector labor market participation, lower crime rates, and a healthier population).

Returns to Education in E&E Countries

Returns to education are linked with structural economic reforms. Return to education investments depends on flexibility in the labor market. In transition economies, flexibility of labor markets is usually associated with the degree to which structural economic reforms have been implemented in these countries, including rule of law, privatization and deregulation.

No empirical evidence has been able to identify the contribution of education to *long run growth* for the transition countries. However, the changes in secondary and higher education in the Central European members of the European Union have led to significant improvements in the quality of education within these countries and are expected to improve long run economic performance.

Returns to completed secondary education show significant variation across countries in E&E:

- **not significant** in comparison to basic education or negative in Russia and Central Asia;
- **high returns in Eastern and Central Europe** – 40 percent in Estonia for men and women; nine percent for men and 13 percent for women in Romania; 35 to 36 percent in the Czech Republic; 41 percent (men) and 47 percent (women) in Slovenia.

In all E&E countries, university education increased earnings relative to the education of other workers. Total returns to university education were in the range of 60 to 80 percent in the Czech Republic and over 100 percent in Hungary (1998); in the Kyrgyz Republic, only university education paid off, but the returns relative to basic education were smaller (17% to 20%) than in Central and Eastern Europe.

B. Health and Economic Development

All of the studies reviewed found a link between health and economic growth. Health has more generally been seen as an outcome of economic development rather than an input to it (e.g., individuals with more income could afford more and better food and were more likely to have money to spend on health care). **More recent studies, however, have determined that improved health and improved productivity (leading to economic growth) and per capita GDP (linked to higher levels of democracy and democratic survival) are mutually reinforcing phenomena.** Furthermore, the World Health Organization (2002) recently concluded in a study that income is particularly important in poor countries in terms of protecting people against the causes of many diseases. And those causes of ill-health can be inter-related, for example, poor nutrition can weaken the body, which may then be unable to fight off infection. Since many people living in poor countries rely on physical labor of some ilk for wages, ill-health can deprive them of the opportunity to earn money, stifling their productivity and per capita GDP (and the economic and democratic development that follows).

Intuitively, it makes sense that health interventions that prevent or decrease an individual's disability or serious illness facilitate higher individual productivity. **Good health, however, is difficult to measure and typically requires imperfect proxies that do not accurately capture the full impact of quality of health on productive capacity.** But several recent studies have estimated the macroeconomic effects of improved health:

- Bloom, Canning, and Sevilla (2003) found **health (measured by life expectancy) is causally related to economic growth**. Their model predicted a four percent increase in output due to one year increase in life expectancy, a stronger finding that in other studies.

- Another study found that in Honduras, Bolivia, and Thailand, **health improvements added about half a percent to the annual GDP per capita income growth** (Jamison, Lau, and Wang, 2005).

- Barro and Sala-i-Martin (1992, 1999) also found that life expectancy was strongly related to growth. **Countries with better health (i.e., longer life expectancy) experienced faster economic growth (in terms of output) than countries with worse health**.

- Nutrition is one component of good health. Several studies included in a WHO report (2002) found that wages were related to caloric intake. **The workers with higher caloric intake were more productive and reported higher wages**.

- Lopez-Casanovas, Rivera and Currais (2005) found that a change in the adult survival rate is an important determinant in long-term economic development. Furthermore, **poor health leads to a decrease in the labor supply and significant opportunity cost, as resources that could be used for other items are spent on curative health care** (both at the individual and societal levels).

- A study by van Zon and Muysken (2005) revealed several important points:

  - The health sector both uses and produces resources for economic growth;

  - **At the macroeconomic level, money spent on preventative and curative care are substitutes, so more people seeking preventative care means less resources dedicated to (more expensive) curative care**;

  - **Declines in health status had a negative impact on any economic activity dependent on number of hours as an input**

  - Increased longevity (life expectancy) led to higher savings and money available for investment, supporting the growth of capital markets, which can help fuel economic development.

- Recent studies in Peru and South Africa also support the theory that ill-health has a negative impact on earnings. A study in Peru found that **workers who had taken a sick day in the previous four weeks experienced a decrease in hourly earnings of one to three percent**. In South Africa, a 2001 study found a **strong negative correlation between earned income and chronic ill-health** such as heart conditions, asthma, or cancer (WHO, 2002).

- One of the large-scale demographic shifts that occurs due to improvements in health is a “demographic dividend.” As health improves, mortality decreases and eventually, families tend to have fewer children. In the intervening years, good health and high fertility create **a baby boom generation that can accelerate economic growth as they enter the labor force** if market conditions allow them to be productively absorbed into the workforce (WHO, 2002).

- **The outbreak of infectious diseases in countries can also have a negative impact on economic development opportunities**. For example, with avian flu in East Asia, cholera in Peru or the plague in India, major trading partners can ban imports and cancel travel along transport routes to prevent the diseases from spreading. Lost revenues from trade and tourism can create huge deficits.

- **Endemic diseases can also prevent foreign investment because investors fear lower return on their investments or exposure to a disease**. The best research in this area focuses on malaria, but it may well hold true for other diseases as well (WHO, 2002).

In more developed economies, there appear to be diminishing returns to investments in health, based on the life expectancy models. Jamison, Lau and Wang (2005), however, hypothesize that data on disability and incidence of disease would be important factors as well, were they available. This conclusion is logical since as countries become more developed, the main causes of death tend to shift from infectious and parasitic diseases to chronic and degenerative diseases (Lopez-Casanovas, Rivera and Currais, 2005, p. 360) and the studies of Peru and South Africa cited above support that position as well.

Because the research on health and earnings is limited to date in the E&E region, we cannot determine how important health is to economic development for this region specifically. It is clear, however, that health is a form of human capital investment. Healthier workers are expected to be more productive and earn more income than other workers, thus supporting economic and democratic development. There is nothing to indicate that patterns of economic development in the E&E countries is so distinct that they would not generally follow the same conditions as other regions of the world. Although the data are scarce from E&E, lessons from other regions indicate that as individual income decreases, the relationship between health and individual productivity is stronger, making this area one of special concern for those countries with low or declining per capita incomes.

C. Active Labor Market Programs[1] and Economic Development

For most households in transitioning countries, wages are the most important form of income, and thus one of the critical components of GDP per capita, which is typically used to measure economic growth. As reported above, higher per capita GDP increases probability of transition to democracy and democratic survival. In times of economic turbulence or transition, governments have often tried several different approaches to assisting those who are unemployed, including active labor market programs. Active labor market programs have had mixed effects on employment and wages. There are four primary conclusions from our review of this literature for transitioning countries.

- **Public employment services generally increase employment and wages.** Studies in specific transition countries showed that participants in these programs more likely to be employed than non-participants. Two studies also showed that employment services reduced unemployment duration, including persons with a history of long unemployment spells. One study found, however, that public employment services are most effective when the economy is growing.
- **Job training programs can improve employment and wages but were determined to be too expensive to be cost-effective in many of the transition countries**. There is mixed evidence on gender differences in the effectiveness of training.

[1] Active Labor Market Programs (ALMPs) are a common term covering a range of interventions that are oriented on assisting the unemployed to regain employment. The term "Active" in this case is meant to distinguish them from the traditional passive form of labor market assistance, i.e., a cash or in-kind transfer referred to as the unemployment benefit.

- **Employment subsidies are not effective policies for increasing employment and wages**. They benefit employers but have no economy-wide impact. In some countries, they were determined to have a negative impact on transition from unemployment to employment.
- **Public employment is not an effective way to improve long-run employment**. Its effects on wages and employment are primarily short-term. These programs are also more expensive per job than other employment policies.

Based on the data available, public employment services and, in some cases, job training programs appear to be the most effective active labor market programs for supporting economic development in the E&E countries.

D. Social Transfers and Economic Development

In general, social systems can affect economic performance directly through improved worker productivity due to higher education levels or better health, but social systems can also affect economic performance through the redistribution of resources. **These changes in the distribution of income can have positive or negative influences on economic growth**. For example, cash transfer programs that require public expenditures financed through taxes or increased debt for current consumption can affect economic growth by changing employment, consumer spending or savings decisions.

Redistributive social spending is consistent with economic growth, both in transition countries and across broader samples, as demonstrated by three cross-country studies. Easterly and Rebelo (1993) found, using several measures of redistribution including marginal and average tax rates as well as estimates of social spending for a large cross section of developed and developing countries, that redistribution policies were not inconsistent with growth. Perotti (1996) found similar results in a cross-country study of forty-nine countries illustrating that redistribution measured by marginal tax rates for different income quintiles had a significant positive impact on economic growth. Keane and Prasad (2002a, 2002b) showed for a sample of transitioning states that cash transfers (measured as a percent of GDP) were positively related to the level of GDP during the transition period of the 1990s.

Social transfers that aim to lessen inequality (thus support democratic survival and potentially economic development) must reach target populations to be effective. Recent studies of reforms in the E&E region show mixed results:

- Keane and Prasad (2002a) argue that **increased social spending in Poland mitigated inequality caused by wage disparities**. Using household budget surveys from 1985 to 1997, they show that despite poor targeting of social cash transfers (including pensions), inequality and poverty was significantly reduced by these payments.
- Hassan and Peters (1996), using household survey data for the early transition period in Bulgaria, show that the **main social benefits offered in Bulgaria were pro-poor and therefore lessened inequality**, again including pensions. Using household

surveys data, Garner and Terrell (1998) reach similar results for the early transition period in the Czech Republic and Slovakia.

- Boeri (2001, 2004) reports that **social protection spending policies reduced income inequality in Bulgaria, Hungary, Latvia, Poland and Slovenia, but increased income inequality in Russia**.
- Misikhina (1999), looking at all social spending programs in Russia from 1994 to1998, concludes **that social benefits were regressive and that relatively wealthy families received a much larger fraction of benefits than poorer families**.

Those countries that developed more effective targeting systems for social transfers have experienced faster economic growth and are generally considered to be more democratic.

Social transfer programs must also be well administered to minimize the costs of redistribution. The socialist redistribution systems that existed were, generally speaking, inefficient. Several countries in the region have realized considerable savings through the reform of social transfer systems, such as disability, pensions, and illness benefits. A recent study in Poland estimates **total savings to public budgets from reforms to be approximately USD 3.5 billion** in 2006. Those savings can then be used to cut tax rates or provide additional services, making the governments more efficient and accountable to their constituents and providing the basis for additional growth.

Inefficient or corrupt social transfer systems can undermine economic growth. Several studies of pension reform programs found striking results. The state-sponsored pension system is typically the largest social transfer program in most countries and provides a good example. Simply continuing the communist-era pension benefits would have resulted in budget deficits of approximately two percent of GDP annually – a fiscally unsustainable expenditure. Poorly administered systems may also create fiscal deficits through tax evasion. A study of Romanian pension systems (DeMenil et al., 1999) shows very high levels of evasion of tax payments for pensions reaching almost 23 percent of all pension tax receipts in 1998. Inability to collect pension taxes requires that the pension fund be supplemented from general revenues, compromising the ability of the government to meet other obligations. **Failure to reform social transfer systems leads to growing deficits, which imply a massive burden on future generations, irrespective of whether the future imbalances were financed by higher payroll contributions, lower replacement ratios, or higher general taxes, all of which may negatively impact economic development**.

Our conclusion from this survey of the relationship between economic growth and social spending is that in the E&E region redistributive income tax and transfer policies promoted economic growth, but this conclusion is based on the analysis from only one very well-done study. However, there is similar supporting evidence from countries in other regions. Furthermore, the cases discussed above illustrate the magnitude of the costs that governments may incur if they fail to invest in reforming basic social investment programs. The policy implication is that targeted or means-tested redistributive policies can contribute to economic growth in the long run.

Social Transfers and Income and Wealth Inequality

It is impossible to adequately describe the variation in social protection programs in transitioning states. These would include long term unemployment benefits, social assistance, early retirement, disability and sickness benefits with different eligibility requirements and different benefits that vary across transitioning states. Programs have been reformed, benefits amended, privileges eliminated and in some cases reinstituted throughout the transition period. Despite considerable differences between countries, however, **the findings of this review suggest that changes in income inequality through targeted income redistribution policies influence poverty and economic growth.**

Central European countries spent considerably more on social protection, and several studies show that this spending, though not perfectly targeted to the poorest households, generally reduced inequality and poverty. States in Eurasia spent considerably less on social protection as a percentage of GDP. These countries were often unable to pay even the most basic social protection—old age pensions. Furthermore, Central European and Eurasian states differ in their ability to effectively target social spending and social benefits to the poor or disabled, which compounds the problem by distributing scarce resources to those who might have other sources of income.

- Keane and Prasad (2002a) argue that in Poland **increased social spending mitigated inequality caused by wage disparities**. Using household budget surveys from 1985 to 1997, they show that despite poor targeting of social cash transfers (including pensions), inequality and poverty was significantly reduced by these payments.
- Boeri (2001, 2004) reports that **social protection spending policies reduced income inequality in Bulgaria, Hungary, Latvia, Poland and Slovenia, but increased income inequality in Russia**.
- Misikhina (1999), looking at all social spending programs in Russia from 1994 to1998, concludes that **social benefits were regressive** and that relatively wealthy families received a much larger fraction of benefits than poorer families.

In summary, reform of social transfer programs, such as old age pensions, disability insurance and social assistance for the poor, can lower program costs, strengthen fiscal sustainability of social programs, and improve the administrative capacities of government. The studies reviewed above on transitioning countries provide evidence that social spending lessened inequality and poverty in the Central European states. They also demonstrate that lower levels of social spending increased income inequality and poverty in Russia and other countries of Eurasia. These studies strongly suggest that targeting transfers to those most in need of assistance (the poor, disabled, and elderly) is crucial for lessening poverty and inequality, thus supporting democratic development, and depending on the model selected, economic growth as well.

IV. SOCIAL SECTOR INVESTMENTS AND GOVERNANCE

In contrast to research on human capital improvement and economic growth, **no *comparative empirical research* on the direct influence of social reforms or social investments on quality of governance was found.** Research on social systems and governance in transition countries was based on country-specific case studies. This section also reviews how policy reforms in social programs have improved different aspects of governance in transitioning states.

- **The most important benefit associated with investments in the reform of social transfer systems is fiscal sustainability**. Cost savings to public budgets, however, are often considerable when reforms occur, suggesting that by not investing in reforms, government budgets continue to spend more of a decreasing budget on inefficient existing social systems.

- **Rule of law (i.e., democracy) can be undermined when/if governments cannot meet their obligations in providing benefits to society**. When public expenditures on social support are not sustainable and, in the most severe cases, fail to meet statutory obligations to supply benefits to eligible households, these circumstances will undermine public budgeting and affect governance.

- **Reform of social transfer programs can improve governance by reducing corruption, but no studies have estimated these benefits**. Such reforms as old age pensions, disability insurance and social assistance for the poor, can lower program costs, strengthen fiscal sustainability of social programs, and improve the administrative capacities of government.

- **Reforms instituted throughout transitioning states have often resulted in more efficient bureaucracies at national and state levels**. These reforms can also provide greater transparency in operation, lower the enforcement agency's costs of monitoring contribution payers, and improve the quality of information available to all the parties involved. All of these help improve governance.

- In Poland, there is evidence that **changes in social service delivery have strengthened links between government and civil associations**. Kerlin's (2002) analysis of local government reforms in Poland reports high levels of cooperation between new county family assistance centers and municipal centers in coordinating services with almost constant contact between the two agencies. In addition, NGO cooperation seemed to flourish under the reforms with 81 percent of urban municipal centers cooperating with NGOs on an informal basis. Almost half of county family assistance centers consulted with NGOs to help decide how money from national funds is allocated and 66 percent rely on NGOs to provide information to help solve specific social problems. This cooperation was not mandated in the reforms.

V. CONCLUSIONS

The review of literature in this survey suggests that social investments and reforms improve economic growth and governance while indirectly contributing to the survival of democratic regimes in the long run. The exact mechanisms whereby social systems influence democratic stability and economic growth are not fully understood, although this review provides clues into some of these processes. Social welfare systems in transitioning countries provide protections and opportunities for citizens that affect individual wealth and offer protections that influence the distribution of wealth in society. By delivering benefits and opportunities to those in poverty or experiencing declines in economic welfare, increased investments in social systems can lower the intensity of distributional conflicts that inevitably occur in politics and reinforce the institutional basis needed for long term economic growth and democratic consolidation.

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