THE SOCIAL SECTOR IN THE CENTRAL AND EASTERN EUROPEAN TRANSITION

THIS BRIEF NOTE SUMMARIZES THE RATIONALE for the priority attention given by the *World Bank* and its CEE members to human resource development in the course of political and economic transition – i.e. why the World Bank has been drawn into the social sectors in CEE; and the strategy for the Bank's human resource involvements in CEE which has evolved, pragmatically, over the last 30 months – i.e. how the Bank has gone about this involvement.

First, a degression on terminology: "human resource development". The terrain could equally be defined as the "social sectors", the "social policy areas" or even "human capital". In fact, the terms are often used interchangeably, to include all aspects of national systems of education, scientific research, training (youth pre-employment and adult-service), health (including population and nutrition), and social security (all benefits provided in cash or kind as part of the social safety net); and most aspects of labor market development, including specifically employment services/promotion and wage determination mechanisms which facilitate the mobility of labor and structure the incentives for human capital formation.

Shelter (housing), though crucial for labor mobility, is excluded, as it is traditionally and more appropriately thought of as belonging, with the full range of municipal services, in the infrastructure sector.

Rationale

The Central and Eastern European (CEE) countries (and now the former Soviet Republics as well) are attempting a historically unprecedented jiu-jitsu trick: the rapid transformation of their societies from totalitarian to democratic politics and from closed centrally directed to decentralized market-based open economies. The purpose is to raise living standards as quickly as possible, in significant measure through achieving an effective integration into Western Europe. There are five fundamental reasons why CEE Governments – and therefore the Bank – give priority attention to the social sectors in this process. The five rationales derive from: the changing role of the state, economic imperatives, fiscal exigencies, social concerns, and politics, each summarized below.

The Role of the State – and of Incentives

By definition, the transition in CEE involves a sharp shift in the boundary between public and private. Two aspects of this change highlight the need to focus on the role of the social sectors.

As private markets are increasingly relied upon in the economic sectors where they work better, the social sectors will constitute a relatively larger share in the remaining legitimate functions of the state. The public's business will be increasingly concentrated in the social sectors. Private markets are immensely efficient when the standard assumptions obtain of perfect competition, perfect information, and no public goods or externalities. But the social sectors are disproportionately characterized by imperfect information, by public or quasi-public goods, and by externalities. So unfettered private markets cannot uncritically be relied upon in the social sectors to attain efficiency objectives, not to mention distributional ones. Public intervention will be necessary. Selecting the proper mix of possible interventions – from among the options of regulation, finance, public production, or income transfers – is critically important for both efficiency and distributional reasons.

As the state share in economic activity shrinks, its control will be exercised increasingly through indirect methods in lieu of direct commands. Most important among these is the establishment of incentive structures conducive to efficient resource allocation. In many instances, social sector policies inherited from the era of central planning positively impede efficient resource allocation in the core economic sectors. Public pension systems which encourage early retirement and treat males and females and specific occupations differently, and wage determination schemes which fail to reward human capital differences, are just two examples. Failure to reform the overall incentive regime within the social sectors will derail the transition just as surely as failure to act in the economic sphere.

Economic Imperatives

The values, attitudes, knowledge, and skills required in the two types of society are vastly different. The human capital accumulated in the past is unsuited, in significant respects, for the desired pluralistic market economies of the future. Productivity, and incomes, will stagnate (or decline) until people have changed their way of thinking about themselves and their societies and until they have acquired very different knowledge and skills. Investments to "retool" the human capital foundations for growth are needed at least as much as those directed at rebuilding the physical capital base of production.

The enormity of these retooling requirements was one of the surprises the World Bank encountered in CEE. Many of us in the Bank – and others – started from much more sanguine assumptions about the adequacy of the human capital base for the transition than turns out to be justified by the facts as they have emerged. Three concrete examples illustrate the general point. School systems in CEE were quite successful in teaching the lower order cognitive skills of recall and comprehension. This ensured universal literacy and a rapid and reliably patterned and passive response to direction from above. Indeed three whole generations were relentlessly trained to take direction and to evade responsibility rather than to exercise direction and assume responsibility. But market economies depend upon the active exercise of individual initiative and creativity and on flexible responses to changing economic opportunities. In OECD school systems, these essential characteristics are fostered by emphasizing the teaching of higher order cognitive skills of application, synthesis and evaluation.† Curricular design in CEE education systems, by contrast, either neglects or (Romania) actively discouraged development of these higher order skills. The implications – for pedagogical methods, educational materials, and training of teachers and administrators – of remedy this situation are profound and far-reaching.

Secondary education and training systems in CEE countries emphasize acquisition of specialized and narrowly-applicable vocational skills.‡ In CEE, secondary education enrollments are typically over 80 percent of age eligibles, of which more than half everywhere are enrolled in narrow industrial apprenticeship-type training programs, and only a small minority (from about 4 percent in Romania to 25 percent in Hungary) in high quality general purpose academic education. By contrast, OECD systems concentrate on providing broad bundles of generalizable academic skills and on developing capacity for rapid acquisition of specific vocational skills, often on-the-job in industry. With admittedly varying degrees of success, secondary education in OECD countries seeks explicitly to build a flexible labor force with very limited capacity for adaptation.

Higher education enrollment rates in CEE – between 10 and 15 percent of age eligibles – are on third to one half the Western European averages and the proportion of the labor force with tertiary education is correspondingly lower in CEE countries. Further, within the narrow coverage of higher education, teaching programs are characterized by a constraining homogeneity and rigidity. All of the following hallmarks of quality and diversity in OECD systems of higher education are severely under-represented or totally absent in CEE: the modern western multiversity with its benefits of interdisciplinary teaching ad research programs (most CEE higher education institutions are quite specialized by field of study), short duration technician (junior college) offerings, continuing education in the professions and for adults generally, organized postgraduate (second and third degree) studies, and credit hour systems which facilitate student transfers among faculties and institutions. Tertiary level teaching and scientific research are typically compartmentalized into separate institutions, thereby precluding the productive interaction between them (and with the economy as a whole) which energizes the system in the west. More seriously still, higher education and scientific research systems in CEE, besides being a decade or more behind frontier disciplinary developments in

---

† This is not to suggest that OECD countries are satisfied with their performance in this respect: far from it, as current debates in the U.S., U.K., and Japan make evident.

‡ An extreme but eloquent example are commercial high schools in CSFR which offer *separate* specializations to prepare students for jobs in retail sales of domestic appliances, clothes, cosmetics and food.

Western Europe (particularly in experimental sciences and engineering where the dearth of modern microprocessor-based equipment is a binding constraint), have simply ignored vast areas of knowledge. This is especially the case in the modern empirical social and behavioral sciences, including economics and management, which are central to the smooth functioning of OECD societies, and in new frontier interdisciplinary fields such as biotechnology, earth sciences, engineering economic systems, materials science, and microelectronics.

Truly massive, systemic, improvements in education and training systems at all levels and in national capacity for scientific research and development will be required to develop the human capital base to energize and sustain the transition in CEE. Coordinated action in many areas is essential. Possibly the single most important is to upgrade the current stock of education materials, from textbooks at all levels to journal holdings and access to international data bases in university and research libraries. Nothing can be done to increase emphasis on higher order cognitive skills, to eliminate excessive specialization, or to expand into the many hitherto neglected fields of study without new materials in immense quantities. This educational materials challenge is daunting, as each link in the production chain for books in CEE countries verges on collapse. Changes of the fundamental nature indicated inevitably take time to design and implement, and even longer to deliver their payoffs. Governments cannot afford to wait to initiate the process. Neither can the Bank, if it is serious about its charter as an economic development institution.

Fiscal Exigencies

In CEE countries, expenditure on social services (as defined above) typically amounts to at least 20 percent of GDP and is preponderantly from public sources. On the one hand, as implied above, waste is pervasive, and for many of the same reasons as in the economic sectors: over centralization, few incentives for cost effective service delivery or for innovative responses to consumer demands, little opportunity for consumer choice, low accountability. A great deal of social expenditure is now irrelevant (directed towards achieving outcomes which are no longer needed) and ineffective (fails anyway to achieve the intended outcomes). On the other hand, unprecedented budgetary stringency must be imposed. Governments are caught inexorably in an excruciating squeeze between the rising prices of goods and services they buy and the declining (at best stable) revenues inherent in the process of stabilization and adjustment.

In these circumstances, maintenance and improvement of social services, and retooling the human capital base to sustain the shift to a market economy, become truly daunting challenges. Central to meeting the challenge is improving the *efficiency* (cost-effectiveness) of social service provision and finance. Tighter targeting is almost always necessary, as is aggressive exploitation of opportunities to diversify responsibility for both, finance and provision – i.e. to tap the capacities of an emerging private sector and of families. Profound changes in structure and management are also essential components of the response to the imperative of enhanced efficiency.

Put succinctly, failure to address the enormous waste of resources in the social sectors, especially in the face of rising demands alluded to above, will explode the public budget, and jeopardize macroeconomic balance during the transition and beyond. Especially in health and social security areas, time bombs are merrily ticking away.

Social Concerns

One admirable hallmark of centrally planned communist societies was their *relatively* egalitarian character. This certainly does not mean that nobody was poor. Indeed, a second surprise of the World Bank's immersion in the region was the realization of the extent of poverty in most CEE countries, despite (or perhaps because of?) the remarkably equitable distribution of income.

But income distribution will no longer be so even. The market will give some people greater prosperity. More seriously, two new phenomena of the transition – inflation and unemployment – will threaten the income of specific groups. The elderly and others dependent upon fixed incomes, single parent families, and families with many children could be severely affected. Many are already living on the edge of destitution. Introduction of wage determination systems whose goal is productive efficiency rather than social welfare will jeopardize living standards of those with little human capital. The normal business cycles and fluctuations in family incomes typical of OECD economies will gradually take hold. All of this will bring with it a very high probability of increased poverty for some, likely significant segments of the population. Protecting the poor and assisting them to escape their poverty and to become productive members of society become central concerns of public policy.

Politics

The advent of democratic regimes means that votes actually count: governments must maintain the support of the people to continue in power. It is unlikely that a government will fall for failure to act rapidly enough to restructure state owned enterprises, to privatize industry, to establish an open trade regime based on a market-determined exchange rate, or to put the banking system to rights. By contrast, social service finance and provision is a privileged domain of governments. While there is certainly room for (more) private sector participation in both areas, one reason for having a government is to ensure social services. Under the former centrally planned regimes, social services like everything else, were sometimes not readily available to all and often poor in quality. The people in the newly democratic societies of CEE are no longer willing to settle for such treatment. In sum, political stability depends at a minimum upon government ensuring that core social services (such as education and health and old age security) do not further deteriorate as the transition occurs, and will require as well extension and improvement of social services into new areas (unemployment compensation, social assistance of last resort).

Any one of these reasons alone would be quite enough to justify priority attention by CEE governments and the World Bank to the social sectors in the transition. Taken together, they constitute a compelling case for a substantially larger effort than either the Bank or its borrowers have so far made. But how to go about it?

Strategy†

As it has evolved in the last 30s, the World Bank's assistance strategy for human resource development in CEE has *three objectives*, which flow in varying degrees from each of the elements of the above rationale.

First, the Bank has sought to ensure that an *adequate safety net* is in place to cushion the adverse impact of the stabilization and adjustment process on vulnerable groups. This has led to concern both for reform of current pension, sickness, and child/family allowance systems. More importantly, it has involved us in creation of entirely new income support programs to cater for those who lose their jobs or cannot find work (unemployment compensation) or who for whatever reasons are destitute (means tested social assistance of last resort).

Second, the Bank has sought to assist the *change in the function of labor markets* from social welfare and redistribution to economic productivity and efficiency. This has led to concern both for employment practices which impede mobility of labor (e.g. restrictions on the authority of a firm to dismiss workers) and for the mechanisms through which wages are set. Of particular importance are efforts to escape from rigid and centrally determined tariff wages, multiple premia or bonuses, and in-kind compensation which were typical in CEE countries. In their place we seek the emergence of flexible pay scales – often established in a decentralized fashion at firm level – which more accurately reflect the relative productivity of different (classes of) workers and result in significant decompression of wages in general.‡ Those productivity differentials are themselves largely a function of prior investments in human capital (especially education and training). Beyond its role in more efficient allocation of factors of production, the decompression of wages

† Strategy, as we use the term, refers conceptually to a hierarchically ordered set of objectives, each with its associated means for achievement of the first objective is in some sense (temporally, or substantively, or both) prerequisite to much movement towards the second, and not until the second is approached will the third come fully into reach.

‡ For macroeconomic reasons centered on the need to control inflation, unfettered firm-level authority to set wages cannot be permitted during the transition. For those firms still operating in uncompetitive markets – i.e. for most medium and large state-owned or recently commercialized enterprises – some form of limitation on the overall wage bill of the firm or on its average wage level must be imposed, to prevent excessive wage increases.

alters radically the incentives for human capital investments. In so doing, it establishes the necessary new framework for development of the education, training, and health systems. It is hard to overemphasize the importance of this fundamental change in labor markets for the transition.

Third, the Bank has sought to support the *structural adjustment of the human capital producing sectors* of education, training, and health to the new political and economic realities. This has led to overriding concern with increasing the relevance and efficiency of these core social services, often through altering the mechanisms through which they are managed and financed.

On a conceptual level, these three objectives are both temporally and logically (substantively) hierarchical. This is as should be the case in a true strategy, and it is useful to think of them in this ordered way. As a practical matter, however, in the hurly-burly of the real world, the distinctions are not so neat. The reorientation and the restructuring of education, training, and health systems necessarily took second place during the early months to the overriding short term preoccupation with the safety net and labor market development. But we certainly have not completed work on these two short term imperatives; similarly we surely have already started to work on longer term core social sector restructuring. Country-specific circumstances have imposed compromises with a purely rational model. Indeed, one major lesson of the experience so far is the practical impossibility of ignoring the longer term structural issues when grappling with key emergency elements of the safety net, such as ensuring an adequate supply of pharmaceuticals, or expanding appropriate retraining opportunities to adults in the workforce, or creating an enabling policy environment and supporting infrastructure for microenterprise development.

* * * *

Such, then, is the general context for the World Bank's extensive support to social sector – and especially education sector – development in Hungary. The *Human Resources Development Project,* assisted with a Bank loan of $150 million, is now under intensive implementation; it addresses key issues in scientific research, higher education, secondary vocational education, and in employment services. The *Ministry of National Education* is preparing an *Education Materials Development Project* for presentation to the Bank in early 1993. A *Pensions Administration and Health Insurance Project* and a companion *Health Services and Management Project,* involving total World Bank support of about $170 million, are expected to be negotiated before the end of 1992.

RALPH W. HARBISON