



Independent Evaluation Office  
*of the* International Monetary Fund

## **THE IMF AND SOCIAL PROTECTION: SEVEN ADVANCED ECONOMY COUNTRY CASES**

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**ABBREVIATIONS**

EC	European Commission
ECB	European Central Bank
EFF	Extended Fund Facility
EITC	earned income tax credit
FAD	Fiscal Affairs Department (IMF)
GDP	gross domestic product
GMI	guaranteed minimum income
ILO	International Labor Organization
MEFP	Memorandum of Economic and Financial Policies
OAP	Regional Office for Asia and the Pacific (IMF)
OECD	Organization for Economic Cooperation and Development
SBA	Stand-By Arrangement
SIP	Selected Issues Paper
TA	technical assistance
VAT	value-added tax

## I. INTRODUCTION

1. **This paper examines the IMF's engagement in social protection issues in seven advanced economies over the past decade.**<sup>1</sup> Advanced economies are the group of IMF member countries classified as such in the *World Economic Outlook (WEO)*.
2. **For advanced economies, the evaluation period of 2006–15 was marked by the global financial crisis**—the worst economic downturn since the Great Depression—and rising social strains sparked by high rates of joblessness and stagnant incomes, particularly among low and middle income groups. In 2008, Iceland became the first advanced economy in more than three decades to receive IMF financial support. As the crisis spread in Europe, the IMF, in partnership with the European Commission (EC) and European Central Bank (ECB)—forming the so-called Troika—extended financial support to four euro area members: Greece (in 2010 and 2012), Ireland (in 2010), Portugal (in 2011), and Cyprus (in 2013). The IMF also deepened coverage of surveillance to social issues related to inequality (e.g., in Japan, Korea, and the United States).
3. **Apart from the impact of the crisis and rising social strains, most advanced economies are also facing an impending demographic challenge of aging**, an outcome of both rising longevity and dropping fertility rates. Although the magnitude and speed of this phenomenon varies by country, none will be immune from enormous pressures on their social protection systems, not only from the standpoint of pensions, but also through its impact on public health care provision, long-term care, and a declining work force to support the aging society.
4. **Most advanced economies have long-standing systems of social protection in place**—94 percent have what the International Labor Organization (ILO) classifies as comprehensive national social security systems (Figure 1). Unlike in low-income countries and many emerging market economies where the informal sector is large, social insurance plays a much larger part in advanced economy social protection systems than social assistance.<sup>2</sup> Thanks to automatic stabilizers embedded in these systems, along with additional public cash transfers

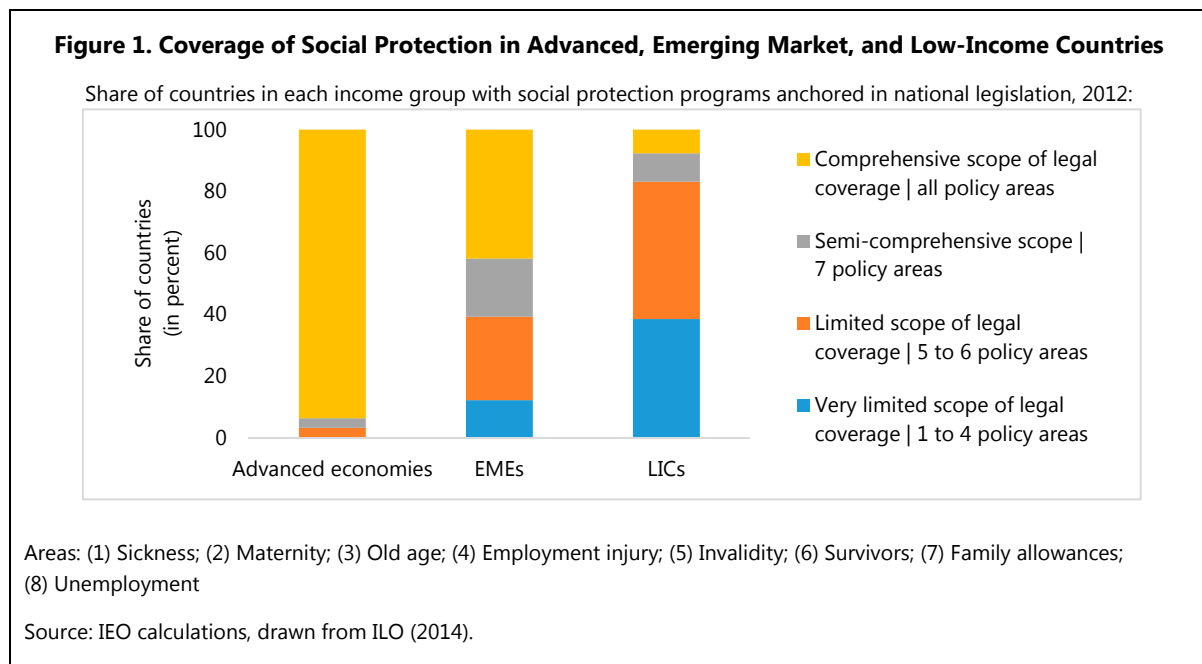
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<sup>1</sup> Social protection encompasses policies that provide cash or in-kind benefits to vulnerable individuals or households, including: (i) social insurance (such as public pension schemes); (ii) social assistance (such as government transfers to the poor); and (iii) labor market interventions for the unemployed (such as unemployment insurance and active labor market policies). This paper does not assess the IMF's work on general policies for development and long-term poverty reduction (such as government spending on education and health), or programs to boost job creation and labor force participation.

<sup>2</sup> As defined in IMF (2014e), social insurance schemes are contributory schemes that require the payment of social contributions by the protected persons or by other parties on their behalf (e.g., employers) in order to secure entitlement to the benefits. Social assistance schemes, on the other hand, provide benefits to the population at large, or segments of the population, funded by general government and without direct contributions to the scheme by, or on behalf of, potential beneficiaries.

in many cases, the impact of the global crisis on real disposable incomes was muted in most countries.<sup>3</sup> But the depth and length of the crisis inevitably took an enormous toll on nearly all of these social protection systems.

5. **This paper looks at seven advanced economies where the IMF was involved in social protection during the evaluation period** in the context of surveillance as well as, in some cases, programs and/or technical assistance (TA): Cyprus, Iceland, Ireland, and Portugal in Europe; Japan and Korea in Asia; and the United States. Four of them (Cyprus, Iceland, Ireland, and Portugal) had IMF-supported programs during the evaluation period, and (except for Ireland) received IMF TA that addressed social protection issues in the context of their programs. IMF involvement in pension system reforms in Greece is covered in Heller (2017).<sup>4</sup>



6. **The paper assesses the IMF’s involvement in social protection in light of the Fund’s mandate and role in social issues as interpreted by the Board and implemented by staff.** As noted in Abrams (2017), relevant Board guidance during the evaluation period did not identify social protection as a required area to be addressed in bilateral surveillance at the level of monetary, exchange rate, fiscal, and financial sector policies. Staff were expected to exercise their judgment and to address the issue if it was considered to be macro-critical or potentially so.

<sup>3</sup> Unemployment benefits, typically the biggest contributor to automatic stabilizers, rose sharply, more than doubling in 2009 compared to pre-crisis and remaining significantly elevated even several years after the crisis onset.

<sup>4</sup> Pension system reforms were the predominant social protection issue the IMF was involved with in Greece.

Similarly, Board guidance allowed for conditionality pertaining to social protection in IMF-supported programs if staff judged such conditionality to be critical for the success of the program.<sup>5</sup> Expertise from the World Bank or other institutions was to be relied upon as far as possible. At the same time, Management, in different degrees, directly called for staff to find ways to ensure that vulnerable segments of the population were shielded from any adverse impact of adjustment, particularly in the context of IMF-supported programs. All this would be expected to generate significant variability in the extent and nature of IMF involvement in individual countries. Examining that variability and, as far as possible, the factors behind it, is a key part of the evaluation.

**7. The country cases focused on three major sets of questions.**

- (i) Why did the IMF become involved in social protection? Specifically, was IMF involvement consistent with the internal guidelines, i.e., prompted by a macro-critical issue and/or the need to protect the vulnerable from adverse effects of program measures?
- (ii) What was the IMF's contribution in the area of social protection, especially vis-a-vis other institutions that were active in that area (if any)? For example, what specific advice or assistance did IMF staff offer? In countries with an IMF arrangement, what kinds of measures were incorporated to mitigate the effects of adjustment on the vulnerable? Did IMF recommendations for and/or conditionality on social protection policies and programs reflect country-specific knowledge of institutional frameworks and implementation capacity? Were they supported with analysis such as poverty and social impact analysis, and were they embedded in the macroeconomic framework? Were they consistent with the advice of other institutions?
- (iii) How effective was the IMF's involvement, including its collaboration with other institutions (if relevant)? Did staff follow up on the outcomes?

**8. The country cases were based on information from desk reviews and interviews.**

Desk reviews analyzed policy documents and guidelines issued to staff, Article IV consultation staff reports and Selected Issues Papers (SIPs), other surveillance and program documents, TA reports, and advocacy and outreach items. Interviews were conducted with staff from the IMF and other institutions, current and former government officials, and other stakeholders.

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<sup>5</sup> In 2014, the guidance added that for all programs, "if feasible and appropriate, any adverse effects of program measures on the most vulnerable should be mitigated" (IMF, 2014d).

## II. MAIN FINDINGS

### A. Why Did the IMF Get Involved in Social Protection?

9. **Since most of the case study countries already had well established social protection systems in place, the IMF's main concerns during the evaluation period were the implications of these systems for fiscal and/or debt sustainability, labor market incentives, competitiveness, growth, and inequality.** Such coverage was mainly focused on fine-tuning aspects of the existing social protection system and ensuring its sustainability, as opposed to developing or expanding social protection schemes. IMF country teams approached social protection policies in the case study countries largely from the perspective of addressing critical macroeconomic and labor-market issues such as the following:

- *Fiscal consolidation and long-term fiscal sustainability:* Amid concerns about large fiscal deficits and growing public debt, the IMF's advice started to shift toward fiscal consolidation in advanced economies in 2010–11. In pushing for fiscal retrenchment, the IMF often stressed entitlement reform as a key component for consolidation (e.g., in the United States). The principal factor motivating the IMF's work on reforming public pension schemes in advanced economies was long-term fiscal sustainability.
- *Unemployment:* The impact of the global financial crisis shifted the IMF's attention toward active labor market policies and unemployment benefit reforms to address the protracted, elevated levels of unemployment in many advanced economies, particularly in Europe. In the latter part of the evaluation period, a recurring theme in the IMF's labor market advice to advanced economies was to reduce employment protection and expand social protection—i.e., essentially to adopt a labor market model of protecting the worker and not the job.
- *Employment and labor force participation:* In some cases, IMF staff addressed the issue of lowering social security contribution rates to stimulate employment. In others, IMF staff addressed pension benefit provisions that could contribute to individuals limiting their labor market participation (e.g., in Japan).

10. **The IMF recognized the importance of minimizing the social costs of adjustment during a crisis program.** Particularly in euro area members where exchange rate devaluation was not an option, the IMF understood that the needed fiscal adjustment and internal devaluation would take a heavy toll on household incomes (Cyprus, Ireland, Portugal).

### B. What Did the IMF Contribute?

11. **The IMF mostly played a supporting role rather than being the main contributor in efforts to minimize the social costs of adjustment in the crisis programs.** In Iceland and Ireland, the two cases where program ownership was highest, the authorities themselves played a key role in designing a fiscal adjustment plan consistent with their social objectives. The IMF



was supportive of their plans, although it endorsed Iceland's social model but urged Ireland to move away from universalism. In Cyprus and Portugal, where cuts to pensions and other social benefits had to be made, IMF staff had to address politically contentious issues regarding how to distribute the burden of the cuts. While the evidence gathered by this evaluation indicates that IMF staff made efforts to shield those at the lowest end of the income distribution, the final policy decisions may not always have reflected those efforts.

12. **Without the World Bank to take the lead on specialized and detailed advice on pension and social security reforms, the IMF provided some TA in this area to the crisis-struck program countries.** At the same time, the IMF was partnered with the EC (and the ECB, forming the so-called Troika) and was required to square its policy proposals with them.<sup>6</sup> The Fiscal Affairs Department (FAD) fielded TA missions to Cyprus and Portugal to develop options for short-term rationalization of public expenditures (including pensions and other social protection expenditures) in support of fiscal consolidation.<sup>7</sup> In the case of Cyprus, an FAD TA mission team of IMF staff and external experts developed a proposal for reforming the social protection system (a structural benchmark under the 2013 Extended Fund Facility (EFF)-supported program)—a task normally led by the World Bank in the vast majority of low- and middle-income countries where similar program conditionality was established.

13. **In the surveillance context, the IMF's main contribution was to add its analysis to an often lively ongoing policy debate in the country on social protection issues.** Pension reform loomed large in Article IV discussions. Labor market reforms were another area where the IMF actively contributed to the policy debate, particularly in Europe but also in other advanced economies facing high unemployment in the wake of the global financial crisis. Depending on country specifics, IMF staff also ventured into other social protection-related issues such as housing assistance (e.g., Ireland), health care insurance (e.g., the United States), and labor market dualism (e.g., Japan and Korea).

14. **The IMF's analysis initially came from a narrowly macroeconomic rather than a social perspective, but took on a broader vision later in the evaluation period.** For example, while IMF staff addressed fiscal sustainability associated with existing pension systems, they usually did not address social issues such as the extent of pension coverage in the population or the adequacy of the pension replacement rate; the social sustainability of the pension system was rarely analyzed. Similarly, analysis of labor markets looked at implications for participation and growth. However, over time the IMF's analysis broadened to take on a wider range of concerns related to the impact of policies on inequality and social cohesion.

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<sup>6</sup> There was no evidence of the Fund collaborating with the Organisation for Economic Co-operation and Development (OECD) on social protection issues in these programs.

<sup>7</sup> A World Bank social protection specialist was part of the TA mission team to Portugal.

15. **The IMF's analytical work was viewed by country officials as being of variable quality, particularly as it extended its range to broader issues beyond the Fund's core macroeconomic expertise** and to link social protection with some of the newer areas of IMF emphasis, such as addressing income inequality. In some cases, the IMF's work was seen as sophisticated and cutting edge, but on other occasions the analysis was seen as simplistic and not adequately reflecting cross-country variations in social structures or differences in social preferences.

### C. How Effective was the IMF's Involvement?

16. **In the program context, the authorities found the IMF's involvement to be generally helpful in ensuring that vulnerable groups were protected from adverse impacts of adjustment measures.** As noted above, the IMF's role in social protection during the programs in Iceland and Ireland was largely a supporting one. The IMF's role in Cyprus was more direct, including program conditionality and TA to support the successful implementation of a guaranteed minimum income (GMI) scheme to support vulnerable groups affected by the crisis. In Portugal, the IMF called for lower and more targeted social benefits, exemption of protection of low-income earners from pension cuts, and active labor market policies to reduce high youth unemployment; however, some of the IMF-supported cuts in social benefits were overturned by the Constitutional Court, highlighting the pitfalls inherent in attempting such politically controversial reforms in a crisis program. Some country officials suggested to the IEO that in retrospect, the IMF did not fully appreciate social and political aspects of reform measures and should have relied more on the EC in designing social protection policies.

17. **Country authorities interviewed for this evaluation expressed mixed views about the IMF's effectiveness in the surveillance context.** When the IMF's recommendations on social protection came across as formulaic, they were often seen by the authorities as not being particularly relevant in their country circumstances. When IMF country teams delved more deeply into the issues (including meeting with the appropriate country experts on those matters), and presented critical analysis in a sensitive way, pointing out inequities, misallocations, and best practices, their work was considered to have value-added in informing the policy debate in the country. The IMF's policy advice had less immediate impact on policy implementation outside the program context, given that these issues are widely studied and subject to contentious political debate. There is also an issue of how well IMF analysis was followed up with outreach to strengthen its impact, particularly when recommendations were at variance with government policies.

### III. COUNTRY CASES

#### A. Cyprus

18. **During the evaluation period, pension reform and the implementation of a new GMI scheme featured prominently in the IMF’s advice on social protection in Cyprus.** The IMF continuously called for the reform of the national pension and healthcare systems in Cyprus, which the Fund viewed as fiscally unsustainable. In the three-year EFF-supported program approved in May 2013, social protection was a central pillar with structural benchmarks on protecting vulnerable groups through better targeted social assistance and the implementation of a new GMI scheme.

19. **The IMF had extensive discussions on pension issues with the authorities in Cyprus in the early part of the evaluation period.**<sup>8</sup> IMF staff considered pension reform a key (“urgent”) policy issue during the 2006 Article IV consultation, and recommended that “[b]esides raising the retirement age back to 65, periodic automatic adjustments should be built in to ensure that the system keeps up with demographic trends” (IMF, 2007a). A 2007 SIP provided analytical support for the IMF’s recommendations on pension reforms (Hoffmaister and others, 2007). The paper was motivated by estimates of the EC’s Aging Working Group, which projected that pension expenditure as a share of GDP in Cyprus could rise rapidly from among the lowest in the EU in 2004 to among the highest by 2050, due to declining fertility rates and increasing life expectancy. Based on simulations of an overlapping-generations model, Hoffmaister and others (2007) called for additional parametric reforms—beyond the reforms envisaged in the authorities’ Convergence Program—including a further increase in retirement ages, switching from wage indexation of pension benefits to price indexation, and lowering the lump-sum payment awarded at retirement. The paper pointed out that public pensions would still be generous after these changes and “welfare would improve for future generations” (Hoffmaister and others, 2007).

20. **The authorities had some reservations about the IMF’s recommendations.** While they also recognized that “the biggest long-term challenge [was] the demographic shock and its possible impact on the social security system,” they pointed to the political sensitivity of raising the retirement age and eliminating wage indexation (IMF, 2007a). Reassured by low public sector debt, they were more interested in measures to raise contribution rates and reverse the decline in the fertility rate (citing the successful example of France). Nonetheless, the authorities found the IMF “instrumental” in Cyprus’ reform process and regarded IMF TA on improving the budgetary framework “very targeted and helpful” (IMF, 2007a).

21. **The IMF was somewhat critical of the pension reforms introduced in 2009.** The Social Security Fund reform, which was adopted by the Cyprus Parliament in April 2009, included measures that increased contribution rates and tightened eligibility criteria, as well as a plan to

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<sup>8</sup> See Heller (2017).

set up an independent body to manage public pension fund assets. Staff acknowledged that the reforms would address long-term fiscal sustainability concerns through 2050, but believed that they were “disproportionately burdensome to workers and competitiveness,” and that additional reforms would become necessary over time (IMF, 2009e). At the Executive Board discussion, the passage of the pension reform was welcomed by Directors although a few Directors agreed with staff that additional reforms “may be necessary in the future” (IMF, 2009e). The authorities, however, considered that the reform was sufficient and had “settled the issue for a considerable period,” while stressing the need to move on to other structural reforms, such as decentralization of the public health system (IMF, 2009e). In the 2010 Article IV consultation, staff again called for further reforms of the pension system, noting that the 2009 reform was a first step but more fundamental reforms were needed to prevent the pension system from increasing the strain on public finances (IMF, 2010e).

**22. When the global financial crisis affected Cyprus in 2009, the IMF began to call for more targeted social assistance.**

- The 2009 Article IV discussions centered on policies to manage short-term risks without endangering medium-term sustainability and the need for “living within means” (IMF, 2009e). Staff were concerned about the authorities’ hiring plans and wage increases, as well as other spending plans, which they viewed as “neither timely, temporary, nor targeted” (IMF, 2009e). However, staff’s call for “targeted social support measures” was general and without specifics, with a vague reference to revisiting “untargeted schemes that were introduced in the past” (IMF, 2009e).
- As the economy contracted and the fiscal balance turned from a small surplus to a deficit of some 6 percent of GDP in 2009, staff advised the authorities to achieve their stated goal of reducing the deficit to 3 percent of GDP by 2012 through reductions in the government wage bill and “better targeting of social transfers” (IMF, 2010e). According to the 2010 Article IV staff report, social transfers accounted for an estimated 30 percent of public expenditure or 14.4 percent of GDP in 2010. The staff report discussed how to reduce this spending by reforming the Cost-of-Living Allowance (COLA) system, but did not discuss which social transfers were poorly targeted or how to target them better.
- At the time of the 2011 Article IV consultation, the authorities announced that they had improved the targeting of social transfers based on income criteria.<sup>9</sup> The staff report included an itemization of “an array of poorly targeted social benefits” amounting to 5.5 percent of GDP in 2010 (much less than the 14.4 percent of GDP listed in the previous staff report). These benefits included non-contributory social welfare benefits and social pensions, child grants, special grants to pensioners, housing grants, educational grants

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<sup>9</sup> In October 2011, the government introduced a package of measures to restore market confidence, including a six-month freeze of COLA adjustments for public servants and improved targeting of social transfers.

and scholarship benefits, and other items. IMF Executive Directors applauded these adjustments measures as a “credible signal of the authorities’ commitment to medium-term fiscal consolidation” (IMF, 2011h).

23. **The IMF became more actively involved in social protection after Cyprus requested financial assistance in 2013.** Cyprus went into recession in 2011, followed by a severe banking crisis a year later, as its large banking sector (about eight times of its economy at the time) was considerably exposed to Greece. Unlike in other crisis-hit European countries, the resolution to the banking crisis was not based on a government bailout, but rather on a private-sector “bail-in” approach, which implied substantial haircuts for creditors, including Cypriot depositors, and the closure of a large Cypriot bank. In May 2013, the Executive Board approved the country’s request for a three-year EFF arrangement in the amount of SDR 891 million (563 percent of quota, about €1 billion).<sup>10</sup>

24. **The IMF was concerned about the impact of adjustment policies on vulnerable groups.** The EFF-supported program included tough financial and fiscal policies to restore financial stability and place debt on a sustainable downward path. The first pillar of the program involved the restructuring and recapitalization of the two largest insolvent Cypriot banks through the “bail-in” of bank creditors. The second pillar of the program entailed a comprehensive fiscal consolidation plan underpinned by structural fiscal reforms.<sup>11</sup> The consolidation measures amounted to about 12 percent of GDP during 2013–18, to achieve a primary fiscal surplus of 4 percent of GDP by 2018. According to IMF staff and government officials interviewed by the IEO, the IMF was concerned about the impact of these adjustment policies on vulnerable groups, including the working poor, who might fall through the cracks of the extensive but poorly targeted social protection system. Moreover, the IMF team was keen to avoid the social fallout that was experienced earlier in Greece. These concerns were acutely shared by the authorities.

25. **To address its concern for vulnerable groups, the IMF pressed for better targeted social benefits.** The EFF-supported program included structural conditionality on social protection, most importantly on the reform of the social welfare system and the implementation of a new GMI scheme (Table 1). Staff observed that while social protection spending in Cyprus had increased “significantly” over the past decade, there had been “significant leakage to richer groups,” giving as an example the fact that less than 15 percent of child benefits and less than 10 percent of student grants went to the poorest quintile of the population (IMF, 2013b). They attributed the leakage to inefficiencies due to “a scattered allocation of responsibilities across ministries and agencies” and “inadequate means testing” (IMF, 2013b). The authorities shared

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<sup>10</sup> The European Stability Mechanism (ESM) contributed about €9 billion. Program monitoring was conducted by the IMF, the EC, and the ECB through their respective Memoranda of Economic and Financial Policies.

<sup>11</sup> According to the staff report for the program request, a parametric pension reform introduced in January 2013 had “significantly improved the long-term viability of the pension system” (IMF, 2013b).

staff's assessment and committed to developing an action plan by end-June 2013 to reform the social welfare system to minimize overlaps in benefits and improve targeting (IMF, 2013b).<sup>12</sup> The program included the implementation of this reform by end-2013 as a structural benchmark.

26. **The IMF and the EC had a coordinated approach to social protection during their concurrent programs.** The social welfare reform measures were specified in greater detail in the Memorandum of Understanding (MOU) on Specific Economic Policy Conditionality for the EC (IMF, 2013b; 2013g). The MOU for the EC laid out the monitoring and review process of key intermediate steps in the areas of pension reform and reforms of social assistance and the social safety net. In the latter area the focus was on consolidation and streamlining of existing benefits, improved targeting,<sup>13</sup> and the introduction of the GMI scheme.

Structural benchmark (unless otherwise specified)	Date introduced	Result
1. Rationalization of housing benefits (prior action).	Initial program (May 2013)	Met.
2. Adoption of measures to improve the targeting of social assistance, consolidate welfare programs, and streamline administrative cost; by end-December 2013.	Initial program (May 2013)	Benchmark revised in first review.
3. Implementation of a new social welfare system to improve the targeting of social assistance, consolidate welfare programs, and streamline administrative cost; by end-June 2014.	First review (September 2013)	GMI introduced in July 2014.
4. Approval by the Council of Ministers of the final design of the reformed social welfare system, including the decisions on the type, level and eligibility criteria for GMI and any remaining benefits, consistent with the 2014 and medium term budget ceilings; by end-March 2014.	Second review (December 2013)	Government approval obtained in mid-June 2014.

27. **The IMF became involved in the design of the social protection system in Cyprus, especially the new GMI scheme.** Two FAD TA missions in 2013 provided the analytical and technical basis for IMF policy advice on a new GMI. The TA teams included external experts.

<sup>12</sup> The authorities also committed to continue their reforms of the general insurance pension scheme and the public sector occupational pension scheme to ensure their financial viability.

<sup>13</sup> The targeting improvements, which aimed at reducing the total number of beneficiaries while protecting the most vulnerable, involved: (i) the introduction of a common definition of income sources, financial assets, and movable and immovable property, to be taken into account for means-testing, so as to ensure consistency across different benefit schemes; and (ii) the introduction or tightening of means-testing criteria, on the basis of the above definition, for benefit provision and continued access to benefits by lowering income thresholds, accounting for wealth such as financial assets, movable and immovable property, and broadening the sources of income to be taken into consideration.

- The first TA mission, which took place in the beginning of 2013 (just before the staff-level agreement was reached on the EFF arrangement), evaluated social spending in the context of a broad public expenditure review. The TA team noted that social protection benefits were not sufficiently targeted to those most in need. It recommended that expenditure savings generated through better targeting and the scaling back or elimination of some social benefits could be used to finance an expansion of active labor market programs to better address the social challenges resulting from the economic downturn, in particular, the rise in unemployment.
- The second TA mission visited Cyprus in June 2013 (soon after the EFF arrangement was approved by the IMF Executive Board), to develop a proposal for the reform of the social protection system in the face of increasing unemployment and decreasing household incomes.<sup>14</sup> The TA team evaluated various components of the social protection system, including the unemployment benefit system, the public assistance program (which was transformed into a GMI program), active labor market programs, etc. The team discussed design issues and experiences from other countries. The team proposed to leave the existing unemployment benefit system unchanged, but advised the authorities to consolidate, streamline, and target other social benefits, in order to generate additional fiscal space to finance the scaling-up of the GMI program. Members of the TA team told the IEO that they worked so closely with the authorities that the TA report was essentially a joint product.

28. **IMF staff made efforts to follow up on the status of the welfare reform measures.**

At the fifth, sixth, and seventh reviews in June 2015, IMF staff reported that the GMI had been introduced in July 2014 and indicated that the authorities would “carefully monitor the implementation of the new social welfare system including an assessment of targeting accuracy and coverage of the GMI, as well as building a national benefit registry to detect and prevent abuse” (IMF, 2015e). At the ninth review in January 2016, staff reported that the authorities had prepared plans to unify the legislative and administrative framework for all disability benefits and had built a registry of benefits and cross-checked it with other databases. As for the assessment report of the implementation of the GMI, the staff report indicated that: (i) the authorities had shared preliminary information with the mission in November 2015 but no report had been prepared; and (ii) the authorities had not yet initiated an examination of the overall welfare reform to identify potential efficiency gains from the consolidation of all information on welfare programs (IMF, 2016a). FAD staff informed the IEO that they were unable to obtain further information on the progress with the GMI program implementation in 2016.

29. **Overall, both staff and the authorities felt the IMF’s involvement in social protection in Cyprus had been effective.** In an *IMF Survey* article shortly after Cyprus exited the

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<sup>14</sup> The team included IMF experts on GMI, active labor market policies, and fiscal issues, as well as an expert from the World Bank on GMI.

EFF arrangement in March 2016, the country team reflected on the main achievements of the program: “On the fiscal front, the Cypriot authorities carried out a strong fiscal adjustment under difficult economic circumstances. At the same time, they also took care of the most vulnerable by adopting a well-targeted income support scheme. As a result, while overall public spending was reduced, the vulnerable received adequate assistance.”<sup>15</sup> Country authorities interviewed for this evaluation viewed the IMF’s involvement favorably, noting that the IMF-supported program provided an opportunity to push through social welfare reforms that had been on the radar screen of policymakers for a long time. According to them, IMF staff “knew exactly what needed to be done” and Cyprus was a “cooperative partner.”

## B. Iceland

30. **Iceland experienced a severe economic and financial crisis in 2008.** Its banking sector collapsed. Public finances deteriorated as a result of the banking crisis. The unemployment rate rose rapidly as output contracted. With the housing bust and large depreciation of the krona, households with mortgages (especially those denominated in euros or Swiss francs) saw their equity wiped out and their debt skyrocket. In November 2008, the IMF approved a two-year SDR 1.4 billion (about US\$2 billion or 1,190 percent of quota) Stand-By Arrangement (SBA) to support the country’s program to restore confidence and stabilize the economy. To alleviate the social impact of the crisis, the IMF-supported program tried to achieve fiscal adjustment and debt restructuring without compromising Iceland’s Nordic system of social benefits.

31. **There was little discussion of social protection by the IMF before the onset of the crisis.** This was not surprising, given that Iceland was experiencing robust economic growth, with a sound fiscal position and a very low unemployment rate (below 1½ percent). Furthermore, unlike most other advanced economies, pension reform and the demographic challenges of aging were rarely on the table in Article IV discussions, likely reflecting the fact that Iceland’s pension system relies only minimally on a public pillar and thus has limited direct fiscal implications.<sup>16</sup>

32. **One issue raised by the IMF pre-crisis with a social dimension was reform of the Housing Financing Fund (HFF), but the main objective was to reduce market distortions.** The HFF was set up to promote home ownership, particularly among low-income or remote households. Concerned by the HFF’s increasing dominance in the residential mortgage market, during the 2007 Article IV consultation the IMF called for reforms to “permanently remove the distortion” created by the HFF by separating from it the social component that provided targeted support for the needy. Specifically, staff recommended that the social lending aspect of the HFF

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<sup>15</sup> “Cyprus Turns Economy Around, Successfully Exits IMF Program,” *IMF Survey*, March 15, 2016.

<sup>16</sup> The Icelandic pension system consists of three pillars: a tax-financed public pension, a compulsory second pillar, and voluntary private pensions. The public pension pillar is means-tested and provides a basic provision accounting for 15 percent of average earnings. The second pillar—the occupational pension—forms the cornerstone of the pension system and is a compulsory employer-employee-financed scheme.



should be more focused on the needy and channeled explicitly through the government budget (IMF, 2007d).

33. **In 2008, before the crisis erupted, the IMF was concerned with the budgetary implications of increases in social benefits.** The IMF urged the authorities to maintain a tight monetary policy and restrain the “highly expansionary” fiscal policy, to shore up confidence in the krona (IMF, 2008d). During the 2008 Article IV consultation—with the economy slowing but prior to the full-fledged global financial crisis—the IMF argued that while automatic stabilizers should be allowed to operate fully, the government should “resist pressures to boost spending, including on the wage bill and social benefits” (IMF, 2008d). The authorities did not follow staff’s advice as they were more concerned about the risk of recession (IMF, 2008d).

34. **All this changed in late 2008.** In November 2008, Iceland became the first advanced country in more than three decades to enter an IMF-supported financial program, when the Fund approved a two-year SBA, totaling \$2.1 billion, under the IMF’s fast-track emergency financing mechanism. In the request for the SBA, the IMF noted that Iceland was facing a “perfect storm” of at least five major shocks, one of which was to income and employment: “real wages are expected to fall by as much as 18 percent in 2008–2010, and unemployment is expected to jump to over 8–9 percent in 2010” (IMF, 2008c). At the same time, the IMF expressed confidence in Iceland’s ability to cope with the shock due to its “strong political and social cohesiveness and a tradition of mobilizing broad political support for difficult policies” (IMF, 2008c).

35. **Social protection issues became an important part of the discussions as the crisis in Iceland unfolded, with the authorities leading the efforts and the IMF playing a supportive role.** The projected high fiscal cost of bank restructuring (estimated at 83 percent of GDP at the time) necessitated a medium-term fiscal consolidation program.<sup>17</sup> However, the IMF agreed with the authorities that automatic fiscal stabilizers (primarily related to the sharp increase in unemployment) should be allowed to work in full during the first year of the program (2009) to “cushion the recession that is in store” (IMF, 2008c). Staff supported the decision to delay the launch of the “ambitious” medium-term program of fiscal consolidation until 2010 (a structural condition). To assist the authorities in meeting this commitment, an IMF TA mission visited Iceland in January 2009 to help identify the key weaknesses in Iceland’s fiscal framework. The authorities subsequently identified a number of measures to reduce transfer payments as a key part of the fiscal consolidation effort (IMF, 2009a).<sup>18</sup> In an interview for the *IMF Survey* in

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<sup>17</sup> Direct state support to the financial sector ultimately amounted to some 34 percent of GDP, much lower than the initial estimates which, the authorities noted, were based on “extreme uncertainty.”

<sup>18</sup> These measures included: reforming indexation of benefits to the elderly and those without an income; limiting maternity leave benefits; altering the means-testing for the elderly; and eliminating the government contribution to the rehabilitation fund for the disabled. Consideration was also to be given to further miscellaneous cuts in transfer payments.

February 2009, IMF staff expressed confidence that the program supported “adequate social protection” for those “most seriously hurt by the crisis.”<sup>19</sup>

36. **By the fall of 2009, policy implementation had been set back by a “drawn-out political crisis” and the authorities and the IMF agreed that policies had to be recalibrated to support more rapid fiscal consolidation while protecting vulnerable groups.** With revenues having contracted more than envisaged and the need to adequately finance unemployment benefits, the IMF supported new measures introduced by the government, including increases in social security contributions, surtaxes on high incomes, halting the automatic indexation of social benefits, better means-testing of social benefits (especially child-related, old age, and disability benefits) (IMF, 2009f). The IMF also supported the introduction of measures to protect distressed household debtors while allowing emergency post-crisis measures, like the moratorium on foreclosures, to lapse.<sup>20</sup> Staff interviewed for this evaluation believed it was “inconceivable” to force foreclosure on a large share of households. The IMF program thus focused on identifying “measures that would target those in need and enable borrowers to reduce their payments and remain in their homes.”<sup>21</sup>

37. **The design of fiscal consolidation policies explicitly took into account the authorities’ objective to preserve the basic Nordic welfare state model.** In an SIP on fiscal consolidation options for the 2010 Article IV consultation and third review (Maliszewski and Petrova, 2010), staff explicitly noted the authorities’ desire to maintain the core elements of the Icelandic welfare state and provided fiscal consolidation options accordingly. In an *IMF Survey* article shortly thereafter, the mission chief agreed that “the desire to preserve a high degree of social protection ha[d] guided the fiscal adjustment efforts.”<sup>22</sup> In subsequent reviews, the IMF continued to support the authorities’ commitment to its social welfare state. The government increased social spending in selected areas, such as interest subsidies to ease the debt burden on vulnerable households and developing mechanisms to provide additional social housing where necessary. Active labor market policies also received a boost in spending, particularly in light of a

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<sup>19</sup> “IMF Backs Iceland as It Struggles with Uncertainty,” *IMF Survey*, February 24, 2009.

<sup>20</sup> Households in Iceland were heavily exposed to the housing market crisis and to inflation-indexed and FX-denominated mortgages loans. At the time of the first program review, about 20 percent of Icelandic households had negative equity in their housing properties, and many others would encounter negative equity as housing prices could fall further. The temporary freeze on payments of FX-denominated mortgage loans was already lifted in April 2009 and the freeze on foreclosure was expected to expire in October 2009. The IMF and the authorities agreed that these measures had helped to prevent a housing market meltdown but could not be sustained. The IMF advocated voluntary mortgage workouts, and a specified framework for rescheduling for the more distressed households, including temporary debt relief based on repayment capacity.

<sup>21</sup> “Recovery in Sight for Iceland,” *IMF Survey*, October 5, 2010.

<sup>22</sup> “Recovery in Sight for Iceland,” *IMF Survey*, October 5, 2010.

rise in long-term unemployment and the significantly higher unemployment rate among youth and low-skilled workers.

38. **The IMF also adjusted the program’s fiscal targets to accommodate spending on social protection.** At the fifth review, the IMF agreed with the authorities to keep Iceland’s medium-term fiscal targets under review “in light of the additional spending on investment and social protection,” noting that “such easing would still deliver sustainable public debt dynamics” (IMF, 2011b). At the sixth review, the IMF agreed to “modestly” reduce the fiscal target after the authorities—as part of the wage agreements with social partners—agreed to increase social benefits more than planned, but cautioned against further slippages (IMF, 2011f).

39. **At the end of the program, the IMF lauded the authorities’ efforts in preserving their social model during the crisis.** In an October 2011 speech at the University of Iceland, the IMF Deputy Managing Director said: “Iceland should be proud of its social model. Even though the last three years have been incredibly challenging, you have gone through the fire while protecting your social welfare system—a lesson that other countries in crisis should emulate” (Shafik, 2011). The Ex Post Evaluation of the 2008 SBA concluded that “[a]greement on a fiscal adjustment consistent with the authorities’ objective of preserving Iceland’s social model was key in easing the social impact of the crisis and fostering program ownership” (IMF, 2012c). The 2012 Article IV staff report commended the authorities on their approach to protecting the most vulnerable, and included a substantial discussion on “Safeguarding Iceland’s Social Welfare System” that highlighted the rise in targeted social benefits during the crisis and its positive impact on reducing the number of households at risk of poverty and lowering the Gini coefficient (IMF, 2012b).

40. **In the years following the end of the program, however, the IMF increasingly expressed concern about the fiscal implications of maintaining Iceland’s social model.**

- In the initial years following the crisis, as the Icelandic economy continued its recovery, the IMF made little mention of social protection issues other than to highlight the need for an orderly resolution of the HFF, with particular emphasis on better targeting of the social mortgage lending objective. The 2013 Article IV staff report went a little further, concluding that “there is little fiscal space for additional household debt relief” (IMF, 2013e). It called for improving the existing debt restructuring processes and advised that any new measures should be targeted only on distressed households “falling through the cracks of existing programs” (IMF, 2013e).
- By the time of the 2014 Article IV consultation, the IMF began to express concerns that the sharp increase in social benefits expenditures during the crisis had yet to be fully unwound, despite improvements in the macroeconomic position and progress in job creation. Staff noted that there were “important structural fiscal challenges to be addressed over the medium term” and urged the authorities to reconsider the medium-term fiscal strategy to achieve the broad objectives of improving growth

prospects, maintaining momentum in dealing with crisis legacy issues, and “ensur[ing] adequate protection for vulnerable social groups” (IMF, 2015b).

- IMF staff also identified growing pension and health expenditures, due to unfavorable demographic trends, as a long-term concern. The sixth post-program monitoring report cited the Icelandic authorities’ own estimates of around 24 percent of GDP in unfunded pension liabilities which would need to be met from 2030 onwards (IMF, 2015f).<sup>23</sup>
- In the 2016 Article IV discussions, the IMF continued to raise the social protection issues in the previous two years, but now added another concern: disability spending. Staff noted that disability spending had been steadily increasing for the past few decades, with sharp rises in disability due to either mental health or musculoskeletal problems. The IMF advised focusing active labor market policies—training and job search support—on disabled workers, and stressed the need to rationalize disability outlays and spending on social protection in order to devote more resources to education, health, and capital spending (IMF, 2016b).

41. **The IMF provided important TA to the Icelandic authorities on major tax reforms,** as part of an effort to assist the authorities designing medium term compositional changes in the budget to support higher potential growth and address inequality. In 2014, an FAD mission advised on value-added tax (VAT) reform at the request of the authorities. The TA report recognized the impact of higher taxes on vulnerable households and calculated the cost of fully compensating households in the lowest quartile of disposable income for higher living costs due to VAT increases. In 2015, an FAD team undertook a study on reforming the personal income tax, with the objective to “improve work incentives by lowering marginal tax rates; to simplify the PIT and refundable credits (child benefit and interest rebate); and to focus those credits, which currently flow to households in all income brackets, on needier households” (IMF, 2015j). They also assisted the authorities in analyzing the distributional impact of tax policy proposals by income decile as well as family structure.

42. **Country authorities, in interviews for this evaluation, were generally of the view that the IMF’s engagement had been very helpful.** They appreciated the IMF’s support for allowing automatic stabilizers to fully operate during the peak of the crisis. They pointed out the important role the IMF had played in bringing the social partners together to reach agreement on cuts in some social benefits. They also commended the IMF for the flexibility in allowing for new measures (such as the housing interest rebate), provided that the government found the fiscal space elsewhere. Importantly, according to the authorities, it was helpful that the IMF

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<sup>23</sup> Iceland reformed its pension system in 1997, establishing a fully funded pension system for private sector workers and public sector workers hired after 1997. At that time, public sector workers were given the option of remaining with the old pay-as-you-earn system or moving to the newly established fully funded system. According to IMF (2015f), the authorities had made some provision for meeting this liability; however, these funds were likely to be exhausted by 2030.

largely left the details of how to achieve the fiscal targets and reform social benefits to the authorities themselves, rather than insisting on particular revenue measures or cuts in expenditures, including social spending. This allowed the authorities to preserve the Nordic welfare state, a point that was raised repeatedly as a key goal of any reforms.

43. **However, the authorities also felt that there could have been more in-depth IMF analysis of the crisis' impact on social protection.** While the authorities recognized the IMF's expertise in areas such as household debt restructuring, they felt that the IMF downplayed the political difficulties. As one official interviewed by the IEO put it, "unprecedented situations required unprecedented solutions," and the IMF could be more open to creative measures in such cases. Moreover, interviewees pointed out that while there was good depth of analysis by the IMF on most aspects of the Icelandic economy, there was much less analysis on the impact on social protection, the political impact, and mitigating measures.

### C. Ireland

44. **During 2006–15, the IMF's involvement in social protection issues in Ireland centered on the social safety net, pension reform, and active labor market policies.** The IMF's involvement took place mainly in the program context: Ireland had a three-year EFF arrangement from December 2010 to December 2013.<sup>24</sup>

45. **At the beginning of the evaluation period, the IMF addressed social protection issues in Ireland from the standpoint of the fiscal stance and long-term fiscal sustainability.**<sup>25</sup> With the Irish economy showing signs of overheating, IMF staff urged fiscal tightening and lamented the substantial fiscal stimulus in 2007 caused by increased spending on social welfare payments, education, and health.<sup>26</sup> However, the authorities pointed to the need to achieve social objectives, and a number of Executive Directors concurred (IMF, 2007e).

46. **At that time, the IMF considered the projected increase in age-related government spending to be the most important fiscal challenge for Ireland.** According to the EC Aging Working Group, cited in the 2007 Article IV staff report and accompanying SIP (Botman and Jakova, 2007), the projected increase in spending over the next four decades was higher than the

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<sup>24</sup> The IMF provided TA to Ireland in the area of monetary, financial, and balance of payments statistics, but not on social protection issues.

<sup>25</sup> Prior to the evaluation period the IMF had rather positive views on social protection in Ireland. The IMF praised Ireland for its low labor tax wedge which contributed to a flexible labor market. It considered Ireland "well placed to cope with the fiscal impact of population ageing, given the low debt ratio and the accumulation of reserves in the National Pensions Reserve Fund;" and noted that Ireland's effective retirement age was one of the highest among industrialized countries (IMF, 2005b).

<sup>26</sup> Donovan and Murphy (2014) describe the expansion in social protection benefits in the boom years leading up to the crisis in Ireland.

average for other EU countries. To prepare for this spending, the Irish Government was setting aside every year 1 percent of Gross National Product (GNP) in a National Pensions Reserve Fund (NPRF). Nevertheless, staff's projections showed that government net debt could rise substantially by mid-century. Based on simulations using the IMF's Global Fiscal Model, staff concluded, and Directors agreed, that increasing the retirement age, broadening the tax base, and raising indirect taxes would be more growth friendly than increasing the social security contribution rate. Staff also suggested introducing a national defined contribution scheme with automatic enrollment to address the inadequacy of private saving for retirement.<sup>27</sup>

47. **In 2009, with Ireland experiencing the full brunt of the global financial crisis, the Article IV mission argued much more strongly for expenditure cuts and better targeted social welfare expenditures.** By that time the authorities had embarked on a substantial consolidation plan including tax increases on middle- and upper-income earners and a pension levy for public sector workers. Staff judged the basic approach and elements of the authorities' plan as "appropriate," noting that the tax increases would reduce the contractionary effect of the consolidation "while also protecting the more vulnerable households" (IMF, 2009b). However, staff called for stronger expenditure consolidation than envisioned by the authorities.

48. **In particular, staff (and Directors) urged the authorities to articulate a strategy that "move[d] away from universalism in social welfare to one that relie[d] more on targeting and incentives"** (IMF, 2009b). Among the measures suggested by staff were means-testing or taxation of child benefits, an earned income-tax credit to support lower-income families, a minimum wage structure that would allow for age-related differentials, and raising social security contributions. At the same time, staff (and a few Directors) expressed some concern that the use of the NPRF for bank recapitalization was diluting its main role as a cushion for long-term obligations related to the aging population.

49. **The IMF also expressed concerns about the impact of the economic stress on vulnerable homeowners.** The 2010 Article IV mission commended the authorities' resolve to tackle their short- and long-term fiscal challenges, noting, in particular, that sizeable cuts to social welfare benefits had been achieved in a "remarkably socially-cohesive manner" (IMF, 2010b).<sup>28</sup> At the same time, the IMF noted that additional support measures might be

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<sup>27</sup> In October 2007 (a couple of months after the Article IV mission), the Irish government published a Green Paper on Pension Policy outlining the demographic and sustainability challenges facing Ireland in the decades ahead and discussing a number of policy reform scenarios and options. As part of the consultation process, an international seminar was held in Dublin in 2008 with speakers from Australia, Ireland, New Zealand, OECD, United Kingdom, and the World Bank (but not the IMF).

<sup>28</sup> In line with staff's recommendations, the 2010 budget focused on expenditure measures including reductions in the wage bill, social welfare benefits, and public services spending, in particular, healthcare and education. The scope of public service pensions was reduced for new entrants, starting in 2010. Staff noted that "[w]ithin the imperative to consolidate, efforts were made to maintain activity and employment, and safeguard those worst hit by the recession" (IMF, 2010b).

needed for a “narrowly-targeted group of vulnerable homeowners” (identified through the welfare system) to limit the economic and social fallout of the crisis (IMF, 2010b). The authorities were, however, concerned that further support measures could raise the risk of moral hazard and strategic default, and create a perception of unfairness (IMF, 2010b).<sup>29</sup>

50. **Notwithstanding the authorities’ fiscal consolidation and bank restructuring efforts, market pressures continued to mount, and in November 2010, the Irish authorities requested financial assistance from the IMF** and its European partners (the so-called Troika) to address the economic crisis.<sup>30</sup> At the outset, the IMF stressed that the program was largely designed by the Irish authorities (based on the National Recovery Plan), augmenting the measures that had already been taken and paying due attention to social protection. In announcing the approval of the EFF arrangement, the IMF Managing Director said: “The authorities designed a program with fairness in mind so that the burden of economic and financial adjustment is shared across all levels of society, with the most vulnerable groups the most protected” (IMF, 2010f). In their December 2010 Letter of Intent (LOI) and Memorandum of Economic and Financial Policies (MEFP), the authorities made clear that social protection would remain a “central policy goal” and means-tested financial assistance would continue to be provided during the program (IMF, 2010f). The MEFP spelled out a number of reforms to the system of social protection, including modification of the mortgage interest supplement scheme within the 2011 Social Welfare Act, adjustments in public service pensions, reductions in social transfers (e.g., working age payments and universal child benefit payments), and reform of the national minimum wage. The aim of these changes was not only fiscal consolidation, but also to create greater incentives to take up employment.<sup>31</sup>

51. **The IMF stressed that the authorities’ adjustment program took “due regard of Ireland’s strong system of social protection”** (IMF, 2010f). Staff highlighted a number of “high-quality fiscal measures” in the National Recovery Plan, including “progress toward full cost-recovery in the provision of water services and tertiary education, while protecting lower-income groups through means-tested support schemes” and welfare reductions via a reform of child and

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<sup>29</sup> The government had already put in place several temporary measures to protect distressed households, such as a mortgage interest supplement scheme which provided support during periods of unemployment or reduced income.

<sup>30</sup> Ireland was the second euro area member to request such assistance, after Greece in May 2010. The SDR 19.5 billion (about €22.5 billion or about 2,322 percent of quota) exceptional access EFF arrangement was part of a financing package amounting to €85 billion from Ireland’s European partners through the European Financial Stabilization Mechanism (EFSM) and European Financial Stability Facility (EFSF), and bilateral loans from the United Kingdom, Sweden and Denmark, and Ireland’s own contributions.

<sup>31</sup> Other longer-range reforms were also planned under the program. The Irish authorities planned to introduce legislation in 2011 to increase the retirement age in incremental steps, rising from the current 65 to 68 by 2028. The national minimum wage would also be reduced, followed by a review of sector-specific minimum wage agreements, with the possibility of eliminating them. Active labor market policies would also undergo reform, with the aim of reducing inactivity and unemployment traps.

disability benefits, and the introduction of a single means-tested social assistance payment for working age people (IMF, 2010f). Staff also approved of the inclusion of labor market activation measures in the recovery plan. Overall, the IMF concluded that the plan achieved a “suitable balance between equity and efficiency,” with “planned welfare cuts ... focused on universal and employment-inhibiting benefits” (IMF, 2010f).

52. **In the first year of the program, IMF reviews simply reported on the government’s social protection initiatives that were described in detail in the authorities’ MEFP.** For example, the first and second program reviews (in May 2011) reported that the Department of Social Protection was preparing a comprehensive program of reforms to better target social spending while removing inactivity and poverty traps, “to ensure that fiscal consolidation [did] not undermine social support to the most vulnerable”; and that “important pension reforms” were being legislated in 2011 that would “materially strengthen Ireland’s long-term public finances” (IMF, 2011a). The third program review (in August 2011) reported that a “sizeable increase in the social welfare pension age from 65 to 68 years—to be introduced in three steps over 2014 to 2028—was legislated at end-June” and a comprehensive public service pension reform bill for new entrants was being prepared for submission to Parliament (IMF, 2011g). The fourth program review (in November 2011) reported that the authorities were making additional spending adjustments in order to reach the original fiscal targets, including “carefully targeted welfare entitlement reforms” (IMF, 2011i). It also reported that the authorities would prepare to implement the revised National Employment Action Plan to ensure the unemployed had adequate incentives and skills to return to work.

53. **As the program progressed, the IMF pressed for social welfare reforms to move away from universal benefits towards targeted support to the most vulnerable groups.**

- The fifth program review (in February 2012) highlighted the high fiscal cost of welfare spending, which consumed more than half of government revenue (IMF, 2012a). The review noted that almost 2 percent of GDP was spent on universal benefits (child benefit, household benefits and free travel for the elderly). Staff laid out a number of reform options—in line with those proposed earlier by the Irish authorities themselves—aimed at moving towards a more means-tested and integrated approach to social welfare payments (e.g., consolidating seven social assistance schemes into a single payment that considered all factors affecting recipient need; extending means-testing of support to the elderly). The sixth review (in May 2012) reiterated the IMF’s support for better targeting of social benefits (child income and working age supports) to those who needed it most.
- The 2012 Article IV mission (and seventh review, in August 2012) noted that strong social protection had helped Ireland retain the second lowest “at-risk-of-poverty” gap in Europe in 2010, but argued that “expensive universal supports and subsidies” were difficult to justify under the budgetary circumstances (IMF, 2012f). Staff saw scope for better targeting of social welfare benefits, including child benefits, medical cards, household benefits package, and subsidies on college fees, “while effectively protecting



the poor” (IMF, 2012f).<sup>32</sup> One suggestion to achieve targeting was to tax some universal benefits. Staff’s advice was supported by an accompanying SIP by the team’s FAD economist which provided a detailed analytical discussion and cross-country lessons to help guide the choice of further consolidation measures that would “be spread equitably across income groups, generations and family types, and protect the most vulnerable” (Abbas, 2012).

- The Irish authorities agreed with the IMF that an expenditure-led consolidation—including improved targeting of social benefits while protecting core public services and the most vulnerable—was the most growth-friendly and appropriate approach to achieving the program’s budget targets (IMF, 2012f). The 2013 budget included cuts in some universal benefits (€10 per month reduction in child benefit and reduced free telephone and electricity allowances for the elderly).
- However, when the IMF continued to press the authorities to do more to cut universal benefits in the 2014 budget (citing again the child benefit, medical cards, and college fee subsidies), the authorities balked, responding that universal supports had already been reduced in past budgets and “there was currently no political appetite for changing the principal of universality” (IMF, 2013h).<sup>33</sup>

**54. Concerned about the rise in structural unemployment, the IMF pressed for efforts to improve the effectiveness of active labor market policies.**

- The fifth program review noted that the unemployment rate was projected to remain in the double digits through the medium term, risking an increase in structural unemployment. It warned that the social protection system was creating unemployment traps and called for “a more targeted use of the state’s resources to support, for example, low-income families engaged in or seeking work; single parents requiring childcare support; and training, internships and up-skilling for the unemployed” (IMF, 2012a).
- The sixth review welcomed the authorities’ Pathways to Work labor activation strategy (Box 1) and called for additional resources (case workers) to support jobseekers in getting back into employment; regular monitoring of training outcomes; and strict application of sanctions for jobseekers that were not complying with activation and training requirements.

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<sup>32</sup> Indeed, the phrase, “ensuring the most vulnerable are protected” or some variant thereof, was sprinkled throughout the staff report.

<sup>33</sup> The 2014 budget included the elimination of certain social protection schemes (e.g., telephone allowance, bereavement grant, and mortgage interest supplement for new applicants) and the reduction of some benefits (maternity benefits maximum rate, jobseeker’s allowance for certain recipients aged 22–25, and illness benefit).

- The 2012 Article IV consultation/seventh review supported the authorities' initiative to reform housing assistance to avoid unemployment and inactivity traps.<sup>34</sup> Staff also suggested reforming the public works program, the Community Employment scheme, to limit entry to the scheme over time to jobseekers without other employment possibilities; and provide suitable training for participants that would help them secure employment after exiting from the scheme. An SIP prepared for the Article IV consultation (Jurzyk, 2012) examined the impact of the welfare system on labor force participation and suggested reform options to improve active labor market policies and rebuild the labor force participation rate, drawing on research by Ireland's Economic and Social Research Institute and the OECD.
- The authorities introduced a range of reforms over the course of 2012–13 along the lines discussed with the IMF, including: launching a new one-stop shop unemployment support service (see Box 1); enhancing engagement with the long-term unemployed through these one-stop shops, the Local Employment Services Network, and other schemes; replacing the existing rent supplement with a new Housing Assistance Payment;<sup>35</sup> replacing the existing pay-related social insurance and Revenue Job Assist schemes with a new and simplified Jobs Plus scheme that offered monthly payments for two years to firms hiring long-term unemployed job seekers; and implementing a pilot project to test the use of social clauses in public work programs.<sup>36</sup>

55. **Pension reforms were not a major feature of the program discussions.** Staff involved told the IEO there was an initial perception that they “should not touch the pensioners” but by end of the first program year, there was a growing perception that the elderly had not contributed as much to the fiscal consolidation effort—in fact, they were seeing a real increase in benefits due to deflation—compared to other population groups that were suffering a loss in income. In the 2012 Article IV consultation/seventh review, based on the analysis in Abbas (2012) and after consultation with OECD pension experts, the IMF suggested a targeted reduction in state pensions which so far had been exempted from the adjustment. Staff suggested reducing or eliminating the (5 percent) difference between the contributory (non-means-tested) pension rate

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<sup>34</sup> According to IMF (2012a) and IMF (2012f), the flat structure of unemployment payments resulted in replacement rates for the long-term unemployed that were high by international standards. The highest replacement rates affected those also receiving housing benefits, resulting in unemployment and inactivity traps that lowered exit rates from unemployment. In 2012, the authorities decided to transfer responsibility for the provision of rental assistance for persons with a long-term housing need from the Department of Social Protection to housing authorities using a new Housing Assistance Payment.

<sup>35</sup> The objective of housing assistance reform was to reduce employment disincentives from the current system, basing the amount of assistance on income levels rather than employment status.

<sup>36</sup> These would require that some publicly funded projects employ a certain share of long-term unemployed job seekers.

and the non-contributory (means-tested) pension rate.<sup>37</sup> (According to staff interviewed, the IMF's European Troika partners were also involved in the consultations but they did not have a "granular understanding" of the issues.) However, changes to state pension payouts were not made, reflecting political resistance to any such cutbacks.

56. **At the end of the program, staff reflected that they had done their best to protect the most vulnerable.** In an interview for *IMF Survey* following the completion of the twelfth and final review under the program, a senior IMF staff member said that "the teams from the IMF, EC, and ECB made a concerted effort to have a dialogue with labor unions and with other organizations that had direct experience in dealing with vulnerable parts of society" and "we encouraged the government to design its fiscal consolidation measures with fairness and equity very much in mind."<sup>38</sup> A background paper for the IEO evaluation of *The IMF and the Crises in Greece, Ireland, and Portugal* (Donovan, 2016) agreed that IMF staff had consistently supported improved targeting of fiscal measures and emphasized the need to protect the most vulnerable. The Ex Post Evaluation of Ireland's Exceptional Access Under the 2010 Extended Arrangement, however, made almost no mention of staff's efforts in this area.

**Box 1. Ireland: Active Labor Market Policies**

The Pathways to Work initiative, launched in February 2012, aimed to improve employment activation policies, by:

- Identifying jobseekers at a risk of long-term unemployment quickly so they could benefit from early interventions such as profiling, group interviews, and subsequent one-to-one interviews and be directed to appropriate training programs. Jobseekers were assigned individual case workers in order to strengthen their engagement with unemployment services.
- Establishing enforcement mechanisms to penalize non-compliant jobseekers, e.g., those that did not attend required interviews, refused to participate in training, or take up jobs.
- Strengthening linkages with employers to ensure that a higher share of vacancies was filled by people from the Live Register.

In October 2012, the authorities launched a new one-stop shop unemployment support service—Intreo—combining the previously separate services of the Department of Social Protection, the Irish National Training and Employment Authority, and the Community Welfare Service. Under the new system, welfare payments were contingent on participation in activation programs and job search efforts, and a lack of engagement resulted in sanctions.

57. **Current and former Irish officials interviewed for this evaluation indicated that the IMF's highlighting of social protection issues was generally helpful.** Most interviewees pointed out that one of the key precepts of the program was to protect the vulnerable, by

<sup>37</sup> According to Abbas (2012), the Irish welfare system did not differentiate significantly between contributory and non-contributory state pensions: there was only a weak link between pay-related social insurance (PRSI) contributions and pension entitlements.

<sup>38</sup> "Ireland's Economy Back from the Brink, But Continued Progress Needed," *IMF Survey*, December 19, 2013.

building on the authorities' National Recovery Plan, which had been formulated before the request for financing. In general, interviewees indicated that the IMF seemed to be amenable to the views of the Irish authorities and understood the need for reforms to be politically feasible and socially acceptable.<sup>39</sup> Indeed, there was very little social unrest in Ireland during the program. Thus, while the IMF pressed repeatedly for targeted, as opposed to universal, benefits, the authorities expressed appreciation that the IMF tried to allow for full national ownership of the program and had not insisted on specific program conditionality on social protection. The IMF's engagement in the area of active labor market policies was viewed very positively, as it was seen as helping the government to overcome inertia in moving forward with a major structural reform. The Irish authorities, however, disagreed with the suggestion in the Ex Post Evaluation that the consolidation could have been at a faster pace or greater scale of consolidation, noting that: "Any further frontloading of consolidation could have jeopardized social consensus and by extension the ultimate success of the program" (IMF, 2015a).

58. **At the same time, some Irish stakeholders (politicians and civil society organizations) criticized the IMF's statements about protecting the vulnerable as largely "lip service."** A few interviewees felt that the IMF's core focus was fiscal sustainability, fixing the banks, and promoting growth, although they acknowledged that the IMF began to focus more on protecting the vulnerable as the program progressed. Some interviewees noted that the IMF, in emphasizing expenditure cuts to achieve fiscal consolidation, was not sufficiently mindful of the adverse impact on the vulnerable.

59. **In discussions after the program, the IMF maintained its emphasis on targeting social benefits.** In the 2015 Article IV consultation, the IMF argued that while the expansion in social protection spending was essential in the crisis, such spending had to decline as the economy recovered, given the limits on fiscal space due to demographic pressures. It reiterated earlier proposals to "generate savings while protecting those on low incomes through means-testing of benefits and taxation of universal benefits" such as making the distribution of medical cards to persons aged over 70 conditional on income, and progressively reducing the universal component of child benefits by treating it as a taxable income (IMF, 2015c). In the 2016 Article IV consultation, the IMF argued that improved targeting of social transfers would help improve intergenerational fairness for the young. This argument was based on an SIP (Chailloux, 2016) showing that according to OECD measures of targeting, a larger share of cash social benefits in Ireland went to the highest quintile of income households compared to the OECD average.

#### D. Portugal

60. **During the evaluation period, the IMF advocated for lower but better targeted social benefits and active labor market programs to combat high unemployment in Portugal.** The IMF had always viewed social benefits in Portugal as too generous and one of the

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<sup>39</sup> A similar finding was noted in Donovan (2016).

key drivers of Portugal's large fiscal deficit; it had also regarded labor market rigidities as one of Portugal's deep-rooted structural deficiencies that hindered the country's competitiveness. When Portugal entered a three-year program with the IMF and the EU in 2011, adjustment policies under the program were geared toward addressing these issues.

61. **However, social protection issues received only limited treatment in the early years of the evaluation period.** The 2006 Article IV report welcomed the government's outline for social security reform and noted that additional fiscal adjustment would be needed to ensure long-term sustainability in light of large increases in pension and health spending in the coming years, but provided little further substance on the issues (IMF, 2006b).

62. **From time to time, the IMF stressed the need to ease employment protection and lower labor costs.** Against a background of a doubling of unemployment and rapidly rising unit labor costs, the 2006 Article IV mission pressed the authorities to improve labor market flexibility and reduce "excessive" employment protection (IMF, 2006b). Moreover, staff raised equity concerns arising from this dual labor market. In the 2007 Article IV consultation, the IMF took issue with the authorities' decision to sharply increase the minimum wage,<sup>40</sup> reiterated the need to relax employment protection legislation (particularly for individual dismissals), and encouraged the authorities to more fully address labor market rigidities (IMF, 2007f). During subsequent surveillance discussions, IMF staff repeatedly observed that Portugal's employment protection remained among the most restrictive in the OECD. The issue of labor market reforms continued to be a core theme throughout both surveillance and program discussions in the following years.

63. **The IMF's calls for reforming the social protection system in Portugal became more urgent in 2009–10.** During that time, the Portuguese economy was severely buffeted by the global economic crisis, and the government policy response included, among other fiscal stimulus measures, some broadening of social protection. The IMF, concerned about longer-term fiscal sustainability, pressed for a structural consolidation of somewhat more than 1 percent of GDP a year on average, especially in the public wage bill and social transfers (IMF, 2010a). Specifically, the IMF urged the authorities to carefully assess the eligibility criteria for social benefits and recommended that unemployment benefits be better-targeted and more incentive-compatible with finding work. It also noted that the planned increases in the minimum wage were now even more out of line with economic fundamentals and should be reconsidered (IMF, 2010a).

64. **Social protection became a central issue in 2011 when Portugal requested emergency financing from the IMF and European partners (the Troika) in April that year.** The IMF viewed generous social benefits and high health costs as key drivers of Portugal's unsustainable fiscal deficit and labor market rigidities as one of Portugal's deep-rooted structural

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<sup>40</sup> The authorities argued that the minimum wage had eroded significantly and that poverty remained a pressing issue (IMF, 2007f).

deficiencies. Accordingly, adjustment policies under the program were geared toward addressing these issues. At the same time, the need to shield the vulnerable from economic shocks and adjustments was a clearly stated goal of the program (IMF, 2011c). The authorities' MEFP included several measures aimed at cutting social benefits, while at the same time protecting lower-income families such as: freezing public sector wages and pensions through 2013, except pensions for those in the lowest categories; levying a special contribution on pensions in 2012, with exemptions for those in the lowest categories; improving means-testing procedures to protect lower-income families while making savings in social security non-contributory benefits; increasing "moderating fees" (similar to co-payments) and reducing exemptions in the health sector, but with means-testing mechanisms put in place to protect the vulnerable; revising unemployment insurance and reforming employment protection;<sup>41</sup> strengthening training opportunities, especially for the low-skilled; and limiting increases in the minimum wage to situations justified by economic conditions and agreed in the context of regular program reviews.

65. **The IMF was supportive of the authorities' aim to protect vulnerable groups in choosing fiscal measures.** IMF (2011c) emphasized the importance of "avoiding socially-disruptive adjustment." In an *IMF Survey* interview, the mission chief emphasized that "the program makes considerable efforts to protect the most vulnerable groups, including those earning the lowest wages and pensions. This is essential for the program's credibility and sustainability. The agreed policy package will enhance means testing for all social transfers. This will help ensure that benefits go to those who need them most."<sup>42</sup>

66. **In program reviews under the EFF arrangement, the sentiment that protecting vulnerable groups would remain a priority was ever present,** even as further policy measures with potential social protection impacts were necessitated by the deteriorating external environment, fiscal slippages, and rising unemployment. For example, during the second review in December 2011, the largest expenditure measure was a two-year suspension of the 13th and 14th monthly wages and pensions (equivalent to a 12 percent average cut). Other measures included higher user fees in the health sector and some additional savings in social benefits through reinforcement of the means testing condition and other eligibility rules (IMF, 2011j). Low-income earners were exempted from pension reductions, as well as tax increases. According to the IMF staff report, "In view of the unavoidable contractionary impact of these measures, the budget also includes, where possible, equity considerations with a view to protecting the most vulnerable. In particular, the wage and pension cuts are to be implemented in a progressive way—only those employees and pensioners who earn above €1,100 per month will be affected

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<sup>41</sup> Among the proposed changes were reductions in duration, capping benefits, and introducing a declining profile of benefits. To extend the social safety net, the contributory period was reduced and eligibility extended to some categories of self-employed. Measures to reform employment protection included reducing severance payments, aligning them for both open-ended and fixed-term hires, and revising restrictive interpretations of fair dismissal.

<sup>42</sup> "IMF Outlines Joint Support Plan with EU for Portugal," *IMF Survey Online*, May 6, 2011.

by the full two-month cuts. Increases in PIT [personal income tax] and CIT [corporate income tax] rates are proposed only for higher incomes (highest PIT bracket) ..." (IMF, 2011j).

67. **The IMF supported a mix of lower unemployment benefits and active labor market policies to address the rising unemployment rate, particularly for youth.** The unemployment rate had reached 14 percent and exceeded 35 percent for the 15–24 age group by the time of the third review, rising further at the time of the fourth review. The authorities, therefore, put increased emphasis on policies to address this challenge, including revisions to the Labor Code, wage subsidies for firms that hire and train certain categories of unemployed, and measures to tackle youth unemployment. A package of active labor market programs was prepared in the fourth review in mid-2012, supported by EU funds.<sup>43</sup> The IMF welcomed this reform package (IMF, 2012e). The authorities also reduced maximum unemployment benefits and shortened the maximum benefit duration, which staff pointed out was "the most generous unemployment benefit system in Europe" (IMF, 2012e).

68. **Some of the IMF-supported cuts in social benefits were reversed amid strong social and political opposition.** In July 2012, Portugal's Constitutional Court ruled that the suspension of the 13th and 14th monthly wages and pensions was unconstitutional because it placed the burden of adjustment disproportionately on public sector workers and was, therefore, inconsistent with equality of treatment under the Constitution. At the fifth review in October 2012, the authorities proposed compensating measures to fill the fiscal gap left by the Court decision, including a PIT surcharge on all monthly incomes above the minimum wage and a scaling down and strengthened targeting of social programs and pension benefits. Staff agreed to these proposed changes "in light of evidence of higher fiscal multipliers that work in Portugal and in other similar cases," and the staff report concluded that the authorities made a compelling case for allowing more time to complete the required fiscal adjustment (IMF, 2012h).

69. **Nonetheless the IMF continued to call for lower and more targeted social benefits.** The 2012 Article IV discussions covered social protection-related issues extensively. An SIP prepared for that consultation by FAD economists (Lemgruber and Soto, 2013) noted that the expansion of social protection during the 2000s had not been effective in alleviating poverty, as a larger share of cash transfers were going to richer households. It suggested that Portugal's reliance on contributory social insurance programs was a main factor behind this feature and could, therefore, even be exacerbating inequality. FAD provided TA in 2013 to help identify reform options that would improve equity and the efficiency of spending, while supporting social

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<sup>43</sup> It included the following programs: a wage subsidy for firms that hired and trained unemployed enrolled in employment centers for six months or more; a targeted initiative which delivered high employability training modules on a part-time basis to allow the unemployed to keep actively searching for a job; a partial accumulation of unemployment benefits and wages to lower the reservation wage for longer term unemployed (at least six months); and a multi-faceted program (training, incentives for employers) specifically targeted at the unemployed youth, one of the groups most affected by the crisis (IMF, 2012e).

cohesion and strengthening social safety nets.<sup>44</sup> The TA report complemented the government's own analysis, with recommendations focused particularly on reforms to the wage bill and pensions. The report argued that substantive pension reform was needed, not only to address fiscal sustainability issues, but also to "correct the existing intergenerational and cross-occupational inequities" (IMF, 2013a).<sup>45</sup> Thus, the IMF urged moving toward equalizing the pension systems of the public and private sectors and not grandfathering current or near-term retirees at the expense of future generations (IMF, 2013a). This TA provided inputs into reforms introduced in the 2014 budget (see below).

**70. Meanwhile, some social benefit cuts and labor market reforms had to be modified in subsequent program reviews.** This reflected, in part, unanticipated shocks, including additional Constitutional Court rulings, which affected the government's ability to meet fiscal targets, and social unrest in response to a proposed fiscal devaluation. The deeper-than-expected recessionary impact of the program also induced policy modifications.

- The proposed fiscal devaluation announced by the government in September 2012 involved reducing the share of payroll taxes paid by firms and increasing the share paid by workers.<sup>46</sup> This caused massive protests and social unrest because it was widely perceived as "robbing workers to pay their bosses," and the proposal was abandoned.<sup>47</sup>
- In 2013, the Constitutional Court rejected cuts in payments to public wage earners and pensioners (again citing the principles of equality and proportionality), increases in contributions on sickness and unemployment benefits (on the basis that this would reduce incomes for recipients below socially acceptable income levels), reforms on eliminating jobs and firing unsuited workers, and the convergence of calculation methods for pensions being paid under public and private pension systems.<sup>48</sup>

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<sup>44</sup> Portugal received considerable IMF TA (particularly from FAD) during the course of the program, but most did not deal directly with social protection-related issues. The 2013 TA (IMF, 2013a) contributed to the authorities' ongoing comprehensive review of the functions of the state, aimed at identifying specific savings measures to underpin adjustment over the next few years.

<sup>45</sup> Prior to the crisis, pension reform was not a priority for the IMF, as Portugal had already undertaken reforms to address concerns that had arisen from the EC's Aging Working Group report.

<sup>46</sup> Initially IMF staff had intended the fiscal devaluation to be achieved by reducing employer contributions to social security and increasing the VAT in a revenue-neutral manner. However, this was seen as undermining the contributory principle of Portugal's social insurance system, so the authorities proposed to shift more of the social contributions from employers to employees. See Eichenbaum, Rebelo, and de Resende (2016) for more on the fiscal devaluation.

<sup>47</sup> "Discontent threatens Portugal's fiscal progress," *Financial Times*, September 16, 2012.

<sup>48</sup> "Portugal court rules against austerity," *Financial Times*, April 5, 2013.



- During the seventh review, and against a background of weaker-than-expected growth prospects, the IMF (and the Troika, more broadly) supported the government's request to revise the deficit targets to allow the operation of automatic fiscal stabilizers (IMF, 2013c). The authorities remained explicitly committed to implementing many of the reforms (through the eleventh review)—particularly with respect to the wage bill and pension reforms—that came out of their Public Expenditure Review (and that was supported by FAD's TA).<sup>49</sup>
- 2014 saw more reversals from the Court, including budget cuts in civil service pay, amendments to the formula for survivor dependents' pensions, and extraordinary levies on unemployment and sickness benefits. Portugal did not complete the Twelfth and Final review following an adverse Constitutional Court ruling in May 2014 and in anticipation of another ruling on wages and pensions later in the year.<sup>50</sup>

71. **The IMF continued to provide advice on social protection in Portugal after the program ended.** The first post-program monitoring report highlighted, once again, the need for reforms to labor markets, pensions, and other social benefits, underscoring that the fiscal outcome would likely diverge sharply over the medium term from the targeted path unless there was renewed reform momentum. It also expressed concerns about a recent agreement to increase the minimum wage, observing that it would likely hurt the vulnerable groups that it was intended to support. In light of the Constitutional Court reversals, together with slippages and the unwinding of measures during the financial program, the social protection recommendations in 2015 and 2016 sounded remarkably similar to those included early in the program and in the pre-program surveillance. For example, two SIPs for the 2015 Article IV consultation (Queyranne and Gaertner, 2015; Jaeger and Gomes, 2015) devoted considerable discussion to social protection, but largely rehashed many of the IMF's previous recommendations. Two innovations, however, were a call to consider an earned income tax credit to fight poverty in lieu of an increase in the minimum wage, and much more emphasis on "a more inclusive and transparent social dialogue" through widening participation to potentially include the unemployed, lower-skilled, and youth, as a trust-enhancing step which could ultimately facilitate greater labor market flexibility (Jaeger and Gomes, 2015). An SIP for the 2016 Article IV discussion (Queyranne, 2016) also assessed the fiscal impact of projected population decline on age-related spending in Portugal and called for, among other measures, a comprehensive pension system reform.

72. **What was the role played by the IMF versus the other Troika members in social protection in Portugal?** It is difficult to disentangle the IMF's engagement from that of the other members, partly because the IMF, EC, and ECB usually released a joint press statement upon completion of each review of the financial program. However, interviews with country

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<sup>49</sup> Among the reforms included in the 2014 budget were an effective increase in the retirement age to 66 years and means-testing of survivor pensions.

<sup>50</sup> "Portugal court ruling on austerity measures threatens tax rises," *Financial Times*, June 1, 2014.

authorities and other local stakeholders provide some indication, albeit mixed, of the relative roles played by the three institutions. According to some, there was a perception that the IMF was more flexible and had a better grasp of the social dimension of the program, in part due to its long experience in dealing with programs in crises. On the other hand, while recognizing that the IMF's primary mandate is macroeconomic policy and financial stability, some interviewees believed that greater priority should have been given to social protection. These interviewees indicated that, while "protecting the poorest segments of the population" was more than just lip service during the program, the mitigation effort and monitoring could have been greater. Similarly, interviewed officials found IMF TA helpful overall, but some thought the social dimension was underplayed and was not fully internalized in the policy recommendations.

73. **Some country officials interviewed by this evaluation suggested that the IMF should have relied more on the EC on social protection policies.** According to them, the EC's familiarity with European social welfare systems gave it an advantage in understanding the political and social complexities of social protection. An example that was cited where the IMF was seen as misunderstanding the political dimensions of the system was the contributory nature of social insurance in Portugal, with benefits proportional to contributions. This universal and contributory aspect was seen as helping to ensure social buy-in and confidence in the system. Yet, according to these interviewees, the IMF pressed the authorities to reduce or eliminate inequalities in the pension systems between the public and private sectors, despite the fact that civil servants had higher qualifications and, hence, higher wages and pension contributions. The contributory social insurance system was not designed as the primary means for redistribution; rather, the tax system was to be progressive, with the objective of redistribution.

74. **While the IMF conducted extensive outreach, interviewees noted that communication with the public was inadequate on the social dimension, contributing to the public's negative bias toward the program.** According to interviews with authorities and other stakeholders, the primary message from the IMF was technocratic, focusing on the need for fiscal consolidation and financial stability; the social impact seemed a side issue. However, interviewees stressed that sustainability entails three dimensions: financial, political, and social. Some interviewees believed that the IMF's reputation suffered the most harm with the proposed "fiscal devaluation." This was seen as a "one-size-fits-all" type of solution, based on theory, but not in line with the practical realities of the Portuguese context. There was also a sense that the crisis situation and the urgency of financial assistance implied an imbalance of power between the Portuguese government and the IMF, with the IMF calling for "shock" measures based on lowering wages, rather than raising quality and value.

## E. Japan

75. **The challenges of aging, and one of the highest public debt ratios in the world, motivated the IMF's advice related to social protection in Japan.** While most advanced economies are facing a demographic shock of population aging, Japan has the distinction of having the highest elderly dependency ratio among advanced economies, which is also rising

dramatically, while the working-aged population is declining sharply.<sup>51</sup> With unemployment low (even after the crisis) and lower inequality and social tensions than in some other advanced economies, IMF advice/recommendations on social protection policies in Japan focused on medium to longer term issues and were notably consistent over the decade-long period covered by this evaluation. Key areas of attention were measures to address spending pressures from an aging population and to finance the social security system, as well as measures to lessen labor market duality. The advice was supported by considerable analytical work.

76. **The IMF pressed for reforms of the social security system to address growing demographic pressures on the budget.**<sup>52</sup> This was a recurring theme of Article IV consultations well before the start of the evaluation period. The 2006 Article IV mission noted that the authorities had undertaken or planned reforms in public pensions and medical care that were designed to keep the rising social security expenditure trend in check (Box 2). However, staff suggested that the government’s projections (of the birth rate) may have been overly optimistic and pointed out that measures still needed to be identified to finance the increased share of the government’s contribution to the national pension scheme. The need for action was further fleshed out in a book, *Tackling Japan’s Fiscal Challenges: Strategies to Cope with High Public Debt and Population Aging*, co-edited by the First Deputy Managing Director (Kaizuka and Krueger, 2006).<sup>53</sup>

77. **The IMF’s main concern with regard to pension reform was the need to support medium-term fiscal sustainability.** In 2008, when the authorities—in an effort to address inequities in the pension system—considered extending the coverage of the basic old-age pension, the National Pension (NP), irrespective of past premium payments, IMF staff’s immediate concern was how to finance the planned increase in the government’s contribution to the NP system (an estimated 0.5 percent of GDP). Staff also suggested that additional reforms, such as increasing the retirement age, might be necessary to support medium-term fiscal sustainability, but the authorities countered that it would be difficult to accelerate the pace of fiscal consolidation given the need for additional social security outlays, and noted that “there was a significant body of political opinion that put economic growth ahead of fiscal consolidation, especially given concerns over increased dualities” (IMF, 2008a).

78. **The IMF strongly supported the idea of increasing the consumption tax to fund social security** as a “politically palatable way to strengthen the fiscal position” (IMF, 2008a). The 2007 Article IV mission noted that linking consumption tax reform—which had been a

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<sup>51</sup> According to OECD Population Statistics data, Japan’s old age support ratio (the converse of the elderly dependency ratio), currently approaching two, will decline to almost one by 2050, still the lowest among the advanced OECD countries.

<sup>52</sup> Indeed, the IMF argued that, contrary to popular perception, the key factor behind Japan’s high public debt was the surge in social security spending due to rapid population aging.

<sup>53</sup> The book combined academic research and views of policymakers.

controversial political issue for some time—with social security funding was “worth considering on pragmatic grounds, particularly if the alternative [was] no action at all,” as “a stepped-up pace of consolidation [would] buy ‘policy insurance’ against shocks and support private spending by alleviating concerns on social entitlements” (IMF, 2007c).<sup>54</sup> An SIP prepared for that consultation (Keen, 2007) made a strong case for increasing the consumption tax (a VAT) as one of the best options for raising revenue to tackle the demographic shock.<sup>55</sup> In concluding the 2008 Article IV consultation, Directors regarded the government’s intention to increase its contribution to the basic pension as “a good opportunity to raise the consumption tax rate” (IMF, 2008a).

### **Box 2. Japan: Public Pension System**

Japan has a universal public pension system consisting of two basic tiers:

- The first tier—the National Pension (NP)—provides a flat-rate redistributive pension. NP participation is compulsory for every resident of Japan aged between 20–60 and benefits are payable from age 65.
- The second tier—the Employees’ Pension Insurance (EPI)—provides a defined-benefit layer that increases as past earnings increase. The EPI covers all private sector employees. The contribution rate (payroll tax) is shared equally by the employee and the employer. The retirement benefit consists of two parts: a wage-related portion and the NP flat-rate benefit. The wage-related benefit at retirement is a function of the number of months the employee has made contributions and his/her average monthly wage over his/her working life. In 2006, the replacement rate was on average almost 60 percent of income. After retirement, the pension increases in line with the CPI. Public sector employees are covered by Mutual Aid Associations (MAA) pension schemes, which are similar in structure to the EPI, and are also run by the government.

There are three categories of insured people: (i) the self-employed, farmers, and students (Category-1 insured), who pay the NP premium and receive the NP flat-rate benefit upon retirement; (ii) private sector employees covered by the EPI program and government employees by MAA schemes (Category-2 insured), who contribute through the payroll tax and receive the NP flat rate benefit in addition to the wage-related benefit; and (iii) nonworking spouses of EPI participants (Category-3 insured) who receive full NP benefits, without having to make contributions of their own. The contributions to the NP system for Category-2 and Category-3 insured are paid for by employers of EPI participants.

By the mid-2000s, the combination of a pay-as-you-go system and an aging society in Japan had already led to pension contributions exceeding expected benefits for younger generations. Against that background, the reform of the public pension in 2004 limited scheduled increases in contribution rates and reduced replacement rates through a system of macroeconomic indexation that linked the growth of benefits to variables such as longevity. In addition, the government increased its contribution to the NP system from one-third to half of total payouts in 2009.

<sup>54</sup> An SIP prepared for the 2006 Article IV consultation (Botman, Edison, and N’Diaye, 2006) had used the IMF’s Global Fiscal Model to investigate the macroeconomic implications of alternative fiscal consolidation strategies and had concluded that an adjustment package with lower social transfers and a higher consumption tax might even have a positive impact on growth.

<sup>55</sup> Keen (2007) dismissed the “widespread perception” that the VAT was inherently regressive, but recognized that redistributive measures might be needed to accompany any increase in the VAT rate to overcome this perception. In that regard, the recommendation was to employ “targeted spending measures” to protect the poor instead of applying a reduced VAT rate to some basic items.

79. **But staff did not neglect social considerations entirely.** The 2008 Article IV mission acknowledged the authorities' "concerns over inequality in net pension benefits between generations, as well as between those covered and not covered by the system" (IMF, 2008a). An SIP prepared for that consultation (Iizuka, 2008) discussed the pros and cons of financing basic pensions entirely through taxes and concluded that such a system would help improve current inter-generational inequality and provide more security after retirement through wider coverage. However, transitioning from Japan's traditional premium-based pension system to a tax-financed system would face challenges such as how to address the increased burden to low-income households (e.g., through coordination with social assistance programs) and how to implement means testing (which had long been an issue in Japan due to the opaqueness of self-employed businesses).<sup>56</sup>

80. **The IMF drew attention to labor market duality in the context of the need for reforms to improve labor utilization.** The 2006 and 2007 Article IV missions highlighted the disparity between regular and non-regular workers, noting that existing regulations favored the employment of non-regular workers, who were excluded from social insurance coverage and had limited job tenure. Staff pressed the authorities to balance the employment conditions for regular and non-regular workers by reducing benefit disparities and weakening employment protection for regular workers. The 2008 SIP on pension reform options (Iizuka, 2008) also drew attention to other impacts of the pension system on the labor market, such as how beneficial treatment of spouses of EPI participants hindered female labor force participation (Box 2) and how the system of reducing benefits for older high-income earners created an incentive for those workers to exit the labor market.

81. **With the onset of the global financial crisis in 2008, the authorities and the IMF put concern for fiscal consolidation and social security reform on hold as Japan's economy plunged into its most severe recession in decades.** Notwithstanding Japan's high public debt, the 2009 Article IV mission supported Japan's sizable fiscal stimulus ("well above the G20 average") that was focused on cash payments, public works, and employment support, and Directors welcomed the steps to strengthen the social safety net (IMF, 2009c). At the same time, the IMF suggested that the authorities should outline a medium-term consolidation strategy that would take effect once the crisis abated.

82. **After the crisis, the IMF returned to the theme of fiscal consolidation through social security and tax reforms, albeit occasionally with a different twist.**

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<sup>56</sup> Iizuka (2008) noted that the authorities' five key pillars for a broader revenue reform of the tax and social security systems were to: (i) correct inequalities among generations; (ii) maximize incentives to work at various stages of life cycle; (iii) improve the credibility and transparency of the social security system; (iv) achieve both medium-term fiscal consolidation of the general government and the pension system; and (v) enhance economic vitality.

- The 2010 Article IV mission stressed that that fiscal adjustment would need to rely mainly on limiting spending growth and finding new revenue sources since there was little scope for cutting expenditures. In addition to letting the fiscal stimulus expire, staff suggested: limiting healthcare costs and other social entitlements; introducing an income cap on social transfers; and raising the statutory retirement age above 65 years. Announcing an upfront increase in the consumption tax, according to staff, would strengthen the credibility of the adjustment plan and boost confidence in the long-term viability of the social security system, which could in turn reduce precautionary savings and help to offset part of the decline in consumption due to the higher tax.<sup>57</sup>
- The 2011 Article IV mission welcomed the authorities' plan to double the consumption tax rate to 10 percent by the mid-2010s to fund social security, but noted that further increases in the consumption tax rate after that, together with caps on spending growth, would be required to bring down the public debt ratio over the medium term. Staff also supported the government's efforts to introduce a taxpayer identification system which would facilitate more effective targeting of social transfers. Staff reported that the authorities' social security reform plan, announced in June 2011, involved an expansion of health and pension spending combined with measures to raise the efficiency of social security spending, but did not provide further details.
- The 2012 Article IV mission focused on intergenerational inequity and income inequality. To help correct the large intergenerational imbalance, staff provided various recommendations for containing social security spending including raising the pension retirement age to 67, collecting contributions from dependent spouses, and clawing back benefits from affluent retirees.<sup>58</sup> An SIP on pension reform options (Kashiwase, Nozaki, and Tokuoka, 2012) provided the analysis underlying these recommendations and elucidated trade-offs between fiscal savings and impacts on economic growth and intergenerational equity.<sup>59</sup> To address concerns about the regressive nature of the

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<sup>57</sup> This argument was mostly conjectural. An SIP for the 2010 Article IV consultation (Berkmen, 2010) acknowledged that the size of the precautionary savings was "hard to identify" and "assume[d] a conservative decline in savings by about 1 percentage points."

<sup>58</sup> In January 2013, FAD and the IMF Regional Office for Asia and the Pacific (OAP) organized a two-day high-level conference in Tokyo on "Designing Fiscally Sustainable and Equitable Pension Systems in Asia in the Post-Crisis World." The conference brought together leading experts and practitioners on pension issues and policy makers from 16 Asian countries. Aside from the need to ensure that the pension system did not run large deficits and was fiscally affordable, key messages from the conference for the design of public pension reforms included: the importance of ensuring that pension systems provided adequate income support for the elderly poor; the importance of increasing the share of the elderly population receiving pensions in emerging Asia; and the need to ensure that pension reforms were perceived as fair.

<sup>59</sup> Kashiwase, Nozaki, and Tokuoka (2012) noted that the measures in the government's tax and social security reform plan adopted in February 2012—eliminating the ad hoc nominal freeze of pension benefits; extending the coverage of the EPI to part-time workers; and consolidating the EPI and the MAAs—were "unlikely to generate

consumption tax, staff suggested introducing targeted transfers to lower-income households, noting that the introduction of a uniform tax identification number would help in this regard.

- The 2013 Article IV mission drew attention to the pressures from health and long-term care spending in Japan. Based on analysis in an accompanying SIP (Kashiwase, Nozaki, and Saito, 2013), the mission recommended that containing rising health care costs (for example, by increasing copayment rates, making more efficient use of hospital resources, and relying more on generics) should be a key element of the medium term fiscal consolidation plan.
- All these points were reiterated in one form or another in the 2014, 2015, and 2016 Article IV discussions.

83. **The IMF also returned to the topic of labor market duality and labor market policies.** Some of these issues were related to social protection, although the IMF's focus was chiefly on boosting employment and labor force participation, particularly among women.

- In the aftermath of the 2011 earthquake and tsunami, the IMF supported the authorities' use of preexisting support systems to provide employment adjustment subsidies to firms to help maintain employment levels and relax eligibility criteria for unemployment insurance (Steinberg, 2011).
- The 2013 Article IV mission, drawing from an SIP prepared by OAP staff (Aoyagi and Ganelli, 2013), highlighted (again) the fact that non-regular workers—who by then made up 35 percent of the labor force—had a much lower level of job security and received significantly less social insurance coverage.<sup>60</sup> Staff (again) called for reducing the difference in employment protection between regular and non-regular workers in order to reduce labor market duality in Japan.<sup>61</sup> However, the staff report did not comment

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fiscal savings." The SIP discussed specific reform options to reduce the fiscal burden such as: raising the basic pension eligibility age to 67; reducing the pension replacement ratio across-the-board by 3 percentage points; and increasing the contribution (payroll tax) rate by 1 percentage point.

<sup>60</sup> Aoyagi and Ganelli (2013) estimated a structural model for a panel of OECD countries to assess the impact of various determinants of labor market duality. Their results suggested that a higher level of employment protection of temporary workers reduced labor market duality.

<sup>61</sup> Staff's recommendations in this area included: introducing a uniform regular employment contract that gradually increased employment protection; clarifying the legal framework for limited regular ("gentei seishain") contracts; and complementary measures to strengthen job matching and support systems.

specifically on the implications of over one-third of the labor force having inadequate social protection coverage.<sup>62</sup>

- The 2015 Article IV mission noted that female labor force participation “got a further boost with Abenomics, possibly as a result of increased availability of child-care facilities and cash transfers to families with children” (IMF, 2015g).<sup>63</sup> (Previous missions had supported the government’s plan to increase childcare services to increase female employment.)
- The 2016 Article IV mission welcomed Abenomics’ “three arrows strategy,” including childcare support to lift the fertility rate and labor force participation; and a social security reform to allow people to continue employment while providing nursing care to family members. Staff supported the government’s floor of 3 percent on annual minimum wage increases and urged the authorities to eliminate disincentives to full-time or regular work due to the tax and social security system such as the spousal deduction and allowance.

**84. Interviews with country authorities indicated that the IMF’s policy recommendations were respected in Japan and that greater outreach by the Fund would have been appreciated.**

The IMF’s repeated support for increasing the consumption tax was considered to have helped the government to move forward with this politically difficult measure. Although the IMF agreed that such an increase, while theoretically regressive, could be made progressive by earmarking the additional revenues for social security, the authorities would have liked staff to have made that point more prominent and do more outreach on this issue in order to convince both the public and the politicians. In general, the IMF was seen as paying more attention to the macroeconomic impacts of policy reform, rather than the impact on social protection. Some interviewees noted that the IMF had focused more on social protection issues in recent years. They largely agreed with the Fund’s policy advice in these areas which they found, in general, well-tailored to Japan. Other interviewees, however, indicated the IMF did not delve deeply enough into some of the social protection areas and gave mostly generic advice. These interviewees were familiar mostly with the Article IV staff reports, but not SIPs or Working Papers.

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<sup>62</sup> Aoyagi and Ganelli (2013) noted that excessive duality could reduce social cohesion and potentially erode support for needed structural reforms. They suggested introducing a single open ended contract for all new hires in which employment protection would increase with tenure, and more generally shifting towards the “flexicurity” model of supporting workers during periods of temporary unemployment rather than protecting specific jobs.

<sup>63</sup> A Working Paper by OAP staff (Kinoshita and Guo, 2015) on female labor force participation, using Norway and Finland as comparators, suggested that shifting from child cash allowances to more public spending on child care could raise women’s labor force participation and potentially increase fertility, although this was not part of the Article IV team’s recommendations to the authorities. The paper was discussed at a seminar hosted jointly by OAP and the OECD in Tokyo in March 2015, which brought together policymakers and academics.



## F. Korea

85. **During the evaluation period, social protection issues were a major part of the IMF’s discussions with Korea, much more so than in many other advanced economies.**

Korea was a surveillance-only country during the evaluation period.<sup>64</sup> Key topics of discussion related to social protection in Article IV consultations were: (i) strengthening the social safety net; (ii) pension reform; and (iii) reducing labor market duality. The topics and recommendations—which were all interrelated—were typically addressed from a medium- to longer-term perspective and also very consistent over time, with changes mostly only in terms of emphasis or motivation. The following discussion is thus organized more thematically than chronologically.

86. **A running theme of IMF surveillance throughout the evaluation period was that Korea’s social spending was below the OECD average and should be increased.**<sup>65</sup> Practically every Article IV mission in the past decade pointed out that social spending in Korea was low compared to its OECD peers. In 2012, staff estimated the “gap” in social spending (between Korea and the rest of the OECD) to be 3½ percent of GDP (IMF, 2012g); in 2013, staff raised the estimate to 6 percent of GDP (IMF, 2014a). The Managing Director echoed this concern in a speech at Seoul National University in December 2013, saying: “Social spending is ... the second lowest in the OECD. Just to give one example: public spending on childcare and pre-primary school is five times higher in Sweden than in Korea, in percent of GDP” (Lagarde, 2013). However, staff reports did not explain why social spending in OECD countries were the “desired levels” that Korea should strive to attain (IMF, 2012g).

87. **TA by FAD in 2005 had contributed to the authorities’ efforts to develop the social safety net following the 1997 financial crisis (Box 3).** The TA mission advised on how to modernize tax policy and administration in order to meet rising medium-term spending needs driven by the aging of the population as well as the government’s intention of better protecting the most vulnerable. At that time, Korean policymakers were interested in the possible adoption of an earnings subsidy. The mission drew on experiences with the U.S. earned income tax credit (EITC) and the U.K. working tax credit to analyze design and administrative issues in implementing an effective EITC in Korea. The TA fell on receptive ears: the authorities introduced an EITC in 2008, a move supported by staff (IMF, 2007g).

88. **The IMF did recommend strengthening the social safety net for its automatic-stabilizer function, although this motivation was not emphasized during the 2008 global economic and financial crisis.** The 2007 Article IV mission noted that “if designed properly, a

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<sup>64</sup> The IMF’s last lending arrangement with Korea (an SBA) expired in December 2000.

<sup>65</sup> Social spending, in the OECD’s usage, refers to “cash benefits, direct in-kind provision of goods and services, and tax breaks with social purposes. Benefits may be targeted at low-income households, the elderly, disabled, sick, unemployed, or young persons. To be considered ‘social,’ programs have to involve either redistribution of resources across households or compulsory participation” (<https://data.oecd.org/socialexp/social-spending.htm>).

strengthened safety net could have important benefits, not only in protecting the poor, but also by ... raising the role of automatic stabilizers in macroeconomic management” (IMF, 2007g).<sup>66</sup> As the global crisis began to unfold in 2008, staff advised that “there could be room for modest fiscal stimulus in the 2009 budget, in particular to protect the most vulnerable should commodity prices rise further, but measures taken should be targeted, well-timed, and reversible” (IMF, 2008b). The 2009 Article IV mission of the following year was supportive of the authorities’ fiscal stimulus package, which included targeted transfers for liquidity-constrained households and a public works program.

### **Box 3. Korea: Main Social Protection Programs**

**Public pensions:** Public pension programs were introduced for civil servants and military personnel in the early 1960s for private-school teachers in 1975 and for the general public—the National Pension Scheme (NPS)—in 1988. The NPS is a partially-funded, defined benefit (DB) system. Participation in the NPS was made mandatory for all citizens (except for civil servants, military personnel, and private-school teachers) in 1999. The contribution rate is 9 percent of the standard monthly income, equally shared between employer and employee. The benefit formula consists of basic and earnings-related portions; benefits are paid mainly in the form of an annuity, which is indexed to prices, with the full pension available at age 60.

**Public assistance programs:** The National Basic Livelihood Security Program (NBLSP), introduced in 2000, provides cash and in-kind benefits, including housing, medical, and educational benefits to those living below the poverty line. Beneficiaries who are able to work are required to participate either in the Self-Reliance Program administered by local governments or in the Employment Success Package Program (ESPP) administered by the Ministry of Labor. The Basic Old-Age Pension (BOAP), introduced in 2008, provides monthly cash benefits for the elderly with low incomes. It covers 70 percent of people aged 65 and above.

**Earned Income Tax Credit (EITC):** The EITC, introduced in 2008, tops up the earnings of poor households with cash benefits up to 1.2 million won (roughly US\$1,100) a year.

**Unemployment insurance:** The Employment Insurance System (EIS), introduced in 1995, combines traditional unemployment insurance with various active labor market programs (ALMPs). Its coverage was expanded rapidly in 1998 to cope with high unemployment in the wake of the Asian financial crisis. The EIS covers around 40 percent of the workforce. Some workers, including the self-employed, are excluded from coverage by law. Others do not participate because their employers cannot afford to pay the contributions for them.

**Public health insurance:** Public health insurance programs were first introduced in the 1970s for civil servants and private-sector workers in large firms. Coverage was gradually increased to encompass the entire population, and all programs were consolidated into the National Health Insurance (NHI) in 1999.

Source: Koh (2015).

89. **An argument emphasized by IMF staff was that strengthened social protection would reduce precautionary savings in Korea, which would in turn increase consumption and growth.** This argument was raised by the 2009 Article IV mission and by subsequent missions, including in the context of concern about Korea’s high current account surplus. The

<sup>66</sup> Further back in time, at the Board discussion of the 2002 Article IV consultation with Korea, “some Directors encouraged the authorities to further develop the social safety net, which would also strengthen the automatic stabilizers” (IMF, 2003).

2013 Article IV mission invoked the assessment in the IMF's 2013 External Sector Report that Korea's current account balance was deemed to be about 3–4 percent of GDP above the level implied by fundamentals and "desirable policies" (IMF, 2014a). Specifically, staff indicated that Korea's social spending was below the "norm" used in the External Balance Assessment methodology, implying that its exchange rate was undervalued.<sup>67, 68</sup> Staff recommended "[b]etter targeting of existing transfers to lower-income households, who have a high propensity to consume" as a way to "boost income but also possibly reduce precautionary saving" (IMF, 2014a). The authorities questioned the staff's analysis, expressing concern about the "mechanical application of the External Balance Assessment/the External Sector Report assessment, given that the norms [were] dependent on staff's subjective judgments in addition to the methodological limitations" (IMF, 2014a). Nonetheless, the 2015 External Sector Report reiterated that an expanded social safety net in Korea could reduce the need for precautionary savings and help reduce the current account gap vis-a-vis the estimated norm (IMF, 2015h).<sup>69</sup>

90. **At the same time, staff noted that "high indebtedness of Korean households" could constrain consumption** (IMF, 2010d). An SIP for the 2010 Article IV consultation (Karasulu, 2010) pointed out that Korea's household savings rate as a share of disposable income had dropped since the late 1990s and was "one of the lowest in the OECD." Part of the reason was the introduction of the mandatory pension system in 1988, which reduced households' incentives to save for retirement. At the same time, the combination of a low pension replacement rate, a low mandatory company retirement age (well below the official retirement age), and high life expectancy contributed to high old-age poverty rates.<sup>70</sup> Retirees often purchased small businesses, in part financed by bank borrowing, to provide retirement income. This contributed to high indebtedness of older cohorts in Korea.

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<sup>67</sup> According to Phillips and others (2013), social spending in the IMF's External Balance Assessment methodology is captured by public health spending as a ratio to GDP.

<sup>68</sup> The 2013 Article IV mission argued that high foreign exchange reserve accumulation entailed costs related to the negative differential between the interest received on reserves and that paid on instruments issued to finance or sterilize the reserves. It pointed out that gross costs from the interest differential alone were around 0.6 percent of GDP a year, "or about 2 times the envisaged FY14 budget support for childcare" (IMF, 2014a).

<sup>69</sup> Every External Sector Report has made the same recommendation for Korea. The 2012 report suggested "improved social protection" as a potential policy response to narrow Korea's "current account gap" (IMF, 2012d). The 2013 report anticipated that "higher social spending" would further narrow the current account gap as "[p]olicies [had] already been put in place to enhance social protection (e.g., subsidies for child care) and further measures [were] envisaged" (IMF, 2013f). The 2014 report pointed to "a need to close Korea's social spending gap" and noted the authorities' "ongoing efforts" in this area (IMF, 2014c). The 2015 and 2016 reports noted that the authorities' more expansionary fiscal policy stance could narrow imbalances, "all the more so if coupled with an expanded social safety net that reduces the need for precautionary savings" (IMF, 2015i; 2016d).

<sup>70</sup> The SIP did not mention the Basic Old Age Pension which the authorities introduced (and the IMF supported) in 2008 to provide help to the elderly with low incomes.

91. **Staff argued that strengthened social protection would reduce household debt, which could in turn increase consumption and growth.** Consistent with the analysis in Karasulu (2010), the 2015 Article IV mission reported that about one-third of the low-income, older, and self-employed households in Korea had high debt servicing burdens. However, as with previous missions, the team assessed that the rise in household debt as a share of disposable income (to above the OECD average) did not pose a systemic near-term threat to the financial sector or the macroeconomy. The 2016 Article IV mission was less sanguine, arguing that “[i]nsufficient social protection” may have contributed to increasing household debt, which represented “both a short-term vulnerability, with possible risks to financial stability, and a structural issue, insofar as high debt can depress households’ propensity to consume and dampen medium-term growth” (IMF, 2016e).

92. **Starting around 2011, the IMF focused more strongly on income inequality and “inclusive growth” as a motivation for higher social spending.** The 2011 Article IV mission advised that “reallocation of spending from economic policy measures toward the social safety net would help address growing social disparities” (IMF, 2011e). The 2012 Article IV mission recommended specific social spending policies to nurture inclusive growth such as expanding early childhood education and childcare programs and vocational training for non-regular workers. An SIP for that consultation argued that, in order to ensure more inclusive growth, the major social protection programs should be better targeted to help those most in need.<sup>71</sup> Subsequent missions repeatedly emphasized inclusive growth as a key policy objective and higher social spending as a key policy remedy. For example, the 2015 Article IV mission pointed to increasing social polarization and the high rate of elderly poverty (characterized as the “worst among the OECD”), and urged the authorities to consider more fiscal redistribution measures (characterized as “among the lowest in the OECD”) (IMF, 2015d). By 2016, staff seemed to view higher social spending as a cure-all: the Article IV mission that year recommended that Korea use its “considerable fiscal space” to implement “a carefully targeted expansion of social expenditure, sustained over the medium term, [which] could address inequality while bolstering consumption and even contributing to financial stability” (IMF, 2016e).

93. **Another recurring focus of the IMF’s social protection advice in Korea was pension reform.** With Korea facing a rapidly aging population, the IMF pressed for pension reforms to forestall a long-term deterioration of the fiscal position.

- The 2006 Article IV mission cited OECD projections showing that population aging could raise the cost of health and long-term care and deplete the assets of the pension system by 2050.<sup>72</sup> Although the pension system posed no short-term fiscal threat, staff called for

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<sup>71</sup> The SIP was subsequently issued as an IMF Working Paper (Elektdag, 2012).

<sup>72</sup> An SIP on long-term fiscal challenges in Korea (Feyzioğlu, 2006) briefly discussed reform the pension system and to contain health and long-term care expenditures.

swift implementation of the authorities' proposal to "restore the national pension system to viability" by raising contributions and reducing replacement rates (IMF, 2006c).

- In 2007, despite Korea having passed a pension reform phasing in a reduction of the benefit replacement ratio, staff recommended increasing the contribution rate and the retirement eligibility age to put the system on a sustainable footing.<sup>73</sup> The Korean authorities pushed back strongly. The Executive Director issued a statement criticizing staff's analysis, concluding that: "While projections based on overly simplifying assumptions and a mechanical plugging-in of numbers may be effective in scaring the public about long-run fiscal sustainability, they are too "illustrative" to draw any practical implications" (IMF, 2007g).<sup>74</sup>
- The 2010 and 2011 Article IV missions continued to stress the urgency of pension reform, the latter pointing out that healthcare and pension expenditures were expected to increase by 11 percent of GDP in 50 years ("almost three times faster than that of the G7 average") and the National Pension Fund would be depleted by 2060 (IMF, 2011e). Staff thus called (again) for further reforms of the public pension system to ensure its long-term sustainability. However, the authorities reiterated their preference for a small government and highlighted the role of individual and occupational pension schemes to alleviate old-age poverty, rather than a reliance on the public pension fund.

94. **Labor market duality and "social polarization" was another recurring theme.** The problems associated with the divided labor market were recognized well before the start of the evaluation period. A 2004 SIP (He and Tressel, 2004) had noted that Korea had the highest share of non-regular (i.e., fixed term) employees among OECD countries and that such workers were paid lower wages, were entitled to fewer benefits, and were not well covered by the social safety net. The IMF had welcomed the government's proposals to reform the industrial relations framework and supported reducing employment protection for regular workers "while simultaneously expanding the social safety net" (IMF, 2005a). A follow-up SIP in 2006 (Miniane, 2006) stressed that the rapidly growing share of non-regular employees compared to regular employees had made income inequality and social polarization major political issues.

95. **The IMF's recommendations were less costly dismissals and better social safety nets.** By 2007, Korea had implemented a labor law aimed at converting non-regular workers to regular status. Nevertheless, the IMF continued to press for reducing employment protection for regular workers and expanding social protection for non-regular workers. The 2010 Article IV

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<sup>73</sup> An SIP on achieving long-term fiscal sustainability (Feyzioğlu, Skaarup, and Syed, 2007) used the IMF's Global Fiscal Model to simulate the impact of age-related fiscal pressures on Korea's economy. The paper concluded that the recently passed pension reform would only delay, but not resolve, the problem.

<sup>74</sup> Specifically, the authorities criticized the analysis in Feyzioğlu, Skaarup, and Syed (2007) for assuming considerably higher fiscal subsidization of the National Health Insurance than allowed under existing legal stipulations.

mission cast this advice in terms of the need to support the reallocation of labor (“supply-side transition”) to rebalance growth away from the export sector (IMF, 2010d). An SIP for that consultation (Eskesen, 2010) used the results of a cross-country panel regression to suggest that institutional reforms in Korea (reducing the strictness of employment protection legislation and aligning unemployment benefits and the share of part-time workers with the OECD average) could have a significant impact on the responsiveness of employment and unemployment to economic activity. In a January 2013 interview with a Korean newspaper, the Managing Director indicated that increased social spending “on workfare, education, and the healthcare program” would be among the policies necessary to transform Korea’s export-dependent economy into domestic-oriented economy.<sup>75</sup>

96. **The IMF argued that reducing labor market duality would help ameliorate income inequality and ensure inclusive growth.** The 2011 Article IV mission pointed out that income inequality in Korea was increasing faster than the OECD average, driven mostly by old-age poverty, labor market practices, and economic polarization between regular and non-regular workers.<sup>76</sup> The 2012 Article IV mission stated that labor market duality “partly contribute[d] to income inequality” (IMF, 2012g). It reported that the government had announced initiatives to strengthen the social safety net—including by subsidizing contributions to social insurance systems by small and medium enterprises (SMEs) to encourage greater coverage of non-regular workers—but continued to press them to do more.

97. **The IMF was persistent in advocating the flexicurity model.** In a December 2013 speech at Seoul National University, the Managing Director highlighted labor market duality as a “key problem” in Korea and suggested reducing it by “boost[ing] social insurance coverage and training for non-regular workers, to bring them inside the fold” (Lagarde, 2013). The 2013 Article IV mission reinforced this message, and additionally recommended that employment protection for regular workers be relaxed. The authorities were not enthusiastic about the latter recommendation (IMF, 2014a). They considered the existence of different work modalities a natural outcome in the labor market, and their priority was to expand social insurance, including through subsidizing low-income employees of SMEs. As for strengthening the social safety net, the authorities stated their preference for social welfare programs that were well targeted, tailored to the differentiated needs of the recipients, and designed to incentivize work.

98. **In principle, the authorities agreed with staff on the benefits of a stronger social safety net and the need to reduce labor market duality, but some found the IMF’s recommendations to be superficial at times.** In interviews for this evaluation, Korean

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<sup>75</sup> “S. Korea needs to pursue ‘different kind of growth’ to promote fairness, efficiency – IMF Chief,” *Maeil Business*, January 2, 2013 (<http://www.imf.org/external/np/vc/2013/010213.htm>).

<sup>76</sup> The mission advised that “[t]ransitioning from the seniority system to performance-based pay would extend the duration of formal employment for the elderly, while extending the coverage of the social safety net would lessen old-age poverty” but it did not discuss the implications of this advice for the problem of labor market duality (IMF, 2011e).

authorities said that in their view, staff did not fully understand country-specific factors, particularly the fiscal governance structure, labor market structure, and cultural aspects such as Koreans' aversion to high debt and preference for a low tax-low welfare system. In a statement delivered at the Board meeting on the 2016 Article IV consultation, the Executive Director for Korea indicated that IMF staff had not adequately taken into account the country's traditional family structure (a "unique cultural characteristic") in assessing its social safety net (IMF, 2016e).

99. **A number of Korean authorities interviewed for this evaluation viewed the OECD's work on social protection as being more influential than the IMF's.** Some interviewees criticized the IMF for benchmarking their social protection system against OECD averages in a mechanical way. For example, the IMF's observation that Korea was among the worst in the OECD with respect to old-age poverty did not consider that the public pension system was introduced relatively recently. And the IMF's claim that Korea had among the lowest expenditures on social protection in the OECD did not acknowledge that such expenditures had been increasing twice as fast as in other OECD countries.<sup>77</sup> Such statements by the IMF, according to those interviewees, only served to cause "controversy and turmoil" in Korea. The OECD's recommendations on social protection, on the other hand, were seen as more concrete and specific. They were also based on Korea's official data, while IMF staff sometimes drew on other data sources, resulting in conflicting statements vis-a-vis the OECD on certain issues such as income inequality.

### G. United States

100. **Social protection issues were a key component of IMF surveillance discussions with the United States throughout the past decade.** The IMF repeatedly called for entitlement reform—of the Social Security, Medicare, and Medicaid systems—in light of the near-term retirement of the baby boom generation. After the Great Recession, the IMF focused on active labor market policies to reduce long-term unemployment. Towards the end of the evaluation timeframe, the IMF emphasized the social safety net and "pro-poor policies" to reduce poverty and lessen income inequality.

101. **The IMF addressed the aging issue in the United States primarily from the standpoint of an unsustainable long-term fiscal outlook in the absence of fundamental entitlement reforms.** Since well before the start of the evaluation period, the IMF had warned of risks to the fiscal outlook arising from long-term demographic pressures on the Social Security and Medicare systems. The IMF repeatedly urged the authorities to establish a credible fiscal framework, with the clear objective of returning the budget—excluding Social Security—to balance over the medium term. By helping to reduce the debt ratio ahead of impending demographic pressures, staff argued, this framework would provide room to phase in reforms needed to place the retirement and health care systems on a sound financial footing. Indeed, a

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<sup>77</sup> According to Koh (2015), welfare spending in Korea was expected to reach a level comparable to that in other OECD countries by the middle of this century.

key topic of discussion in the 2006 Article IV consultation was how to “re-invigorate the momentum for entitlement reform” (IMF, 2006a) and the 2007 Article IV consultation considered the issue “the main fiscal challenge” facing the United States (IMF, 2007b).<sup>78</sup>

102. **Initially the IMF focused more on the healthcare system.**<sup>79</sup> The 2007 Article IV mission noted that the long-term underfunding of Medicare was much larger than that of Social Security and had been markedly increased by a recently-added prescription drug benefit. A large implicit funding gap for Medicaid would also create substantial fiscal challenges for state budgets and federal transfers. Staff strongly endorsed the authorities’ proposals to further link Medicare contributions to income, but were less optimistic about plans to lower provider payments. The IMF also agreed that a key option for reforming Medicaid was to reduce long-term care costs through better targeting of services. Staff called for additional work to identify underlying medical cost drivers (the increase in health care costs was seen as the more important driver of spending than aging) and policy options. In concluding the 2007 Article IV consultation, Directors welcomed proposals to contain the budgetary costs of Medicare spending, while cautioning that sustainability would require “more fundamental reform of the high-cost health system” (albeit without providing suggestions on how to achieve such reform) (IMF, 2007b).

103. **For Social Security, the underlying costs and reform options were already well understood and the main challenge was to develop a consensus on reform proposals.** Staff reported on measures under consideration by the authorities to help put Social Security on a firmer footing, such as indexing benefits to longevity, linking payments to a combination of wage and price indexing, and raising the cap on payroll taxes. Staff supported the idea of progressive indexation, whereby benefits for the wealthy would be slowed gradually while those for the poor were protected. From the standpoint of preserving financial stability, staff agreed with U.S. authorities that moving to automatic enrollment in employer-sponsored defined contribution plans could help boost personal saving (a concern for the IMF in light of large global imbalances).

104. **With the outbreak of the financial crisis in 2008–09, the IMF’s attention shifted to short-term crisis response.** The focus of IMF surveillance during those years was on policy responses to the serious stresses in the housing and financial markets and on economic and financial stabilization. Nonetheless, social protection issues still received some attention. The IMF welcomed the operation of automatic stabilizers and fiscal stimulus measures, including tax refunds for low-income families, aid to states for Medicaid, and additional social safety net spending (e.g., financial assistance for the unemployed and struggling families, and health insurance assistance for the unemployed), as well as efforts to tackle the housing market

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<sup>78</sup> Indeed, as part of the IEO evaluation of *IMF Performance in the Run-Up to the Financial and Economic Crisis*, Dhar (2010) argued that the IMF’s bilateral surveillance of the United States was too focused on long-term concerns like entitlement reform and paid too little attention to the build-up of serious short-term risks in the financial sector.

<sup>79</sup> Health spending is not included under social protection in this evaluation, but is discussed here due to its link to the broader social security system in the United States.



collapse. The IMF even urged that additional fiscal stimulus and further efforts to help households with underwater mortgages could be helpful, providing such efforts were set within a credible medium-term fiscal framework.

105. **But the IMF was also concerned with the crisis' long-term legacy on fiscal imbalances.** Staff stressed that the combined effects of the fiscal stimulus, cyclical impact, and financial support had measurably worsened the fiscal imbalance, adding to the looming pension and health care pressures. The U.S. authorities recognized that health care reform was critical for both growth and longer-term debt sustainability; they indicated that once healthcare reforms had been launched, attention would turn to social security reform, where (fiscal) savings would be smaller but more predictable (IMF, 2009d). At the Board discussion of the 2009 Article IV consultation, Directors emphasized that the healthcare reforms should include substantial measures to reduce costs over the longer term, while aiming at budget neutrality in the short term (IMF, 2009d). They stressed that the impact of cost control measures would need to be carefully monitored, and that additional measures should be taken promptly if envisaged savings failed to materialize.

106. **Entitlement reform came back into focus as the crisis receded.** The 2010 Article IV mission welcomed the major initiative to reform the health care sector—the Affordable Care Act—which would expand coverage to many non-elderly uninsured. But staff were less sanguine than the authorities about the projected “payoffs” that would arise from the envisioned measures (in budgetary terms), and advised remedial measures if the planned cost containment was not fully realized.<sup>80</sup> The Article IV discussions in 2012 and 2013 reiterated the IMF's support for entitlement reform (including full implementation of the 2010 health care reform).<sup>81</sup> The 2014, 2015, and 2016 Article IV missions reported that healthcare cost pressures had declined but more efforts were needed to sustainably lower the path of future healthcare costs. (Staff also suggested higher Medicare premiums to help address financial imbalances in the publicly-funded health system.) Attention also turned to the prospective depletion of the Social Security Trust Fund, which staff advised countering through a gradual increase in the retirement age, greater progressivity of benefits, raising the maximum taxable earnings for social security contributions, and indexing benefits and contributions provisions to chained CPI. These recommendations were presented in the staff report as a laundry list, without further elaboration.

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<sup>80</sup> The 2010 consultation included an SIP (Batini, Callegari, and Guerreiro, 2010) which used generational accounting to assess the fiscal burden placed on future generations by the current generation and to suggest the amount of fiscal adjustment needed to achieve greater inter-generational equity. With rising healthcare costs cited as the main driver of the fiscal gap, it advocated such measures as a permanent cap on the growth of Medicare spending.

<sup>81</sup> A 2013 SIP (Igan, Kashiwase, and Shang, 2013) concluded that, even under optimistic assumptions about the growth in health care costs, entitlement spending would rise due to population aging, requiring measures to lower per capita spending or raise additional revenues.

107. **Starting in 2010, the IMF also began to focus on the persistent weakness in the labor market and the role of active labor market policies.** The 2010 Article IV mission and accompanying SIPs (Dowling, Estevão, and Tsounta, 2010; Batini, Estevão, and Keim, 2010) noted that the unemployment rate was “higher than in any postwar period save a brief point in the 1980s, while unemployment duration, the percent of long-term unemployed, and the number of involuntary part-time workers [were] all at record highs” (IMF, 2010c). The 2011 Article IV mission and accompanying SIP (Estevão and Keim, 2011) recommended a “re-examination of existing active labor market programs (e.g., job training and job-search assistance)” (IMF, 2011d).<sup>82</sup> Staff observed that resources for training and job search support programs were lower in the United States than other OECD countries. The 2012 and 2013 Article IV missions reported on a number of ongoing and proposed labor market initiatives by the U.S. administration such as training and employment programs for dislocated workers, low-income adults, and disadvantaged youth, reforms to the Reemployment Now program to help unemployment insurance claimants get back to work more quickly, and a US\$12.5 billion allocation to the Pathways Back to Work Fund helping low-income workers remain in the labor force and gain new skills. Nonetheless staff continued to argue for a “stronger emphasis on active labor market policies” (IMF, 2013d).<sup>83</sup>

108. **Starting in 2014, the IMF began to focus on labor market policies as a means to reduce poverty.** This was a material development, in that the topic was presented as a major theme and approached as a clear social concern and not just as a macroeconomic challenge to growth, fiscal sustainability, etc.<sup>84</sup> The 2014 Article IV mission made the “troubling” observation that the official poverty rate had been stuck at about 15 percent since the recession, even though the economy had been recovering and average incomes and employment had risen above the levels prevailing in 2007 (IMF, 2014b). Staff opined that lowering poverty would require not just a sustained improvement in the economy and in employment opportunities but also “policy efforts to raise real wages at the bottom end of the distribution and to provide a greater transfer of fiscal resources to society’s poorest” (IMF, 2014b). In that context, staff’s policy recommendations were to (i) further expand the EITC for workers without dependents, low-income youth, and older workers not yet eligible for social security; and (ii) increase the federal minimum wage. Staff argued that while expanding the EITC and raising the minimum wage had some potential

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<sup>82</sup> Interestingly, this was not the first time the Fund had raised such an issue with the U.S. authorities. In 2007, with trade negotiations ongoing under the Doha Round, staff had suggested that “greater support to those temporarily dislocated by rising imports” could help ameliorate the impact of trade on workers and resist pressures to raise tariffs (IMF, 2007b). The authorities, however, did not see a case for greater support beyond the regular social safety net, in light of the difficulties in identifying trade as the cause of specific job losses.

<sup>83</sup> A 2012 SIP (Le Borgne, 2012) argued that the long-term unemployed were “significantly less likely to find a job now than before the crisis,” and that the matching process between job vacancies and the long-term unemployed had become less efficient.

<sup>84</sup> In fact, this was explicitly listed as one of five broad themes of focus in the 2014 Article IV discussions.

downsides, a combination of the two yielded important complementarities, ensuring that more of the benefits would go to the worker.<sup>85</sup>

109. **By the end of the evaluation timeframe, the IMF was highlighting the issue of income polarization as well as poverty, and calling for greater social protection.** The 2016 Article IV staff report pointed out that the United States was an outlier among advanced OECD economies in terms of the poverty rate and social safety net spending.<sup>86</sup> In addition to the expanded EITC and higher federal minimum wage, IMF staff suggested that the personal income tax structure be made more progressive “so as to help mitigate income polarization and assist the working poor” and that social programs to support the nonworking poor be upgraded (IMF, 2016c).

110. **The U.S. authorities largely agreed with the IMF’s analysis and policy proposals and noted that efforts were already underway to advance a policy agenda with greater attention to social protection issues** (IMF, 2016c). The combination of a sustained economic recovery after the crisis (with the unemployment rate being brought down sharply) and the extension of health insurance coverage both contributed importantly to help lower income groups. However, little progress was made on the broader agenda in the context of a deeply divided political system and a lack of a broad consensus in the needed direction for reform.

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<sup>85</sup> Staff provided analytic support for these policy recommendations by referencing the findings from a number of recent research papers from both the IMF and outside sources. The 2014 Article IV staff report also provided estimates of the effects of implementation on employment, take-home pay of poor households, and the poverty rate.

<sup>86</sup> Although Korea and Italy spent less than the United States on their respective social safety nets as a percent of GDP, their poverty rates were significantly lower, according to the OECD and IMF staff calculations.

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