Social Protection for those Vulnerable to Shocks

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1. Introduction

Social protection refers to publicly provided safety nets of two kinds. Of the first kind are poverty alleviation measures which help people born poor or lacking productive assets or skills get out of poverty. The second type consists of social insurance programs or other labor market interventions that allow people to deal with labor market risk. The focus of this chapter is on the social protection systems of the latter type which protect individuals against the negative consequences of shocks in general and external shocks in particular.

We discuss in detail the reasons for the need for such social protection when workers are vulnerable to shocks, especially in a more globalized world. The main reasons we discuss are: (1) For various reasons, the market for private unemployment insurance is missing, making it imperative for the government to step in to fill this void; (2) Social protection increases efficiency by addressing market failures stemming from externalities such as labor-market crowding; (3) It promotes distributional equity by aiding displaced workers facing long unemployment spells or moving costs; (4) And finally, and very importantly, social protection by addressing the above concerns also makes globalization politically more palatable.

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There is a case for social protection when workers are exposed and vulnerable to shocks. Globalization, major components of which are trade reforms and openness to capital flows, is in large part driven by policy. There is therefore some control governments have over this kind of shocks. Political support for globalization means that in democracies a majority of voters support reforms that promote globalization. However, it does not imply that globalization, even in the presence of compensation schemes which make it politically feasible, improves everyone’s welfare. The question then is with what kind of social protection regime in place does globalization lead to an improvement in the welfare of some without hurting anyone else (at least without hurting the majority)? Also, what social protection measures lead to greater improvement in welfare? These are some of the questions we address in this chapter. These issues are intimately related to the government’s choice of compensation schemes or trade adjustment assistance programs. Even if we believe that we already live in a globalized world and the process of globalization is virtually almost complete the issue of compensation to promote support for globalization still remains important. The reason is that, based on past experience of the world economy, by no means can we assume globalization to be irreversible.

Next, we review any literature on the effectiveness of social policies in mitigating employment disruptions caused by globalization. Here we discuss the record of social protection systems in developed and developing countries. We describe and analyze in detail the experiences of East Asian countries in dealing with the financial crisis of the late 1990s. Governments adopted a wide range of policies to mitigate the consequences of the crisis (Cox and Manning, 2001). These included labor-intensive public infrastructure projects, skill-training intervention, provision of employment services, and wage subsidies. We examine in detail the relative success of these policy interventions in mitigating employment disruptions. We find that even though East Asian countries used a variety of policy measures to mitigate the consequences of the crisis, probably, the single most important measure was the Public Works Program, given the large relative size of the informal sector in most of these countries. As these economies develop more and the size
of the informal sector shrinks, they can move towards social protection instruments used in developed countries, something that we describe in detail later.

Next we compare the different systems of social protection within the developed world. In developed countries, the social protection measures used can be classified into the following categories: (1) Unemployment Insurance; (2) Employment Protection; (3) Public Works Program; and (4) Trade Adjustment Assistance Programs. Apart from Trade Adjustment Assistance programs, the other three have been used to different degrees also in developing countries. Here we discuss the relative ease of implementing each policy, the policy’s relative effectiveness in helping workers adjust and the policy’s effects on market efficiency.

We also examine different approaches to funding social protection systems and their effect on markets. Countries differ in the way these programs are financed. For example, in most countries unemployment insurance is financed by a flat tax on employers. In the US it is experience rated whereby firms with greater turnover end up paying more. This comparison of these alternative ways of financing these social protection programs turns out to be quite useful.

In developing countries, given the large size of the informal sector, even if unemployment insurance is offered, it is going to have very limited coverage. These countries have relied heavily on employment protection policies in the formal sector. These include mandatory severance packages and firing restrictions. However, these measures lead to high costs of separation between firms and workers, discouraging them from hiring workers and a more than optimal capital intensity of the input mix in labor abundant countries. Studies have shown that this hurts overall productivity and income levels. We get here into the question of what kind of a reform in social protection developing countries need. Given the large size of the informal sector, public works programs are going to remain an important instrument of social protection. However, these programs are often plagued by corruption. As well, since these programs are funded by general revenue, the underdeveloped internal revenue infrastructure is a constraint here.
Finally, we discuss the “best practice” among governments. The Danish “flexicurity” system which combines generous unemployment benefits with strict monitoring of the job search activity of the unemployed has come for a lot of praise and we incorporate some elements of that into our discussion of best practices. We also discuss the recent modifications and redefinitions of it by the European Commission that takes a broader view of flexibility and security and supports more flexibility in the model based on cultural and social norms. For example, the extent of moral hazard associated with unemployment insurance that monitoring tries to alleviate may depend on the social norms in a country. Therefore, what works in one country may not work in another.

2. Rationale for social protection in a more globalized world

2.1. Missing market for insurance against income risk

In addition to improving welfare by providing consumption smoothing opportunities, insurance against labor market risk has other benefits too. As pointed out by Acemoglu and Shimer (1999), insurance against labor market risk can increase efficiency by promoting the emergence or expansion of more risky jobs and industries. In a similar vein, lack of insurance can lead to outdated and less efficient production technologies or portfolio choices such as holding livestock as a form of precautionary saving (Rosenzweig and Wolpin 1993). It can also adversely affect human capital accumulation as households use child labor to smooth consumption in response to a negative income shock to the family.

The next question to answer is that in market economies why we need governments to provide protection against labor market risk. Why can’t individuals self-insure? Why doesn’t the market provide insurance against the labor market risk?

According to Ehrlic and Becker (1972) self-insurance works well when the shocks are relatively frequent and losses are moderate. Therefore, if unemployment spells are short and frequent, self-insurance can work to some extent. However, self-insurance may lead to too little saving for consumption smoothing during times of crisis particularly among low income people. Also, self-insurance is clearly inadequate during times of large aggregate shocks such as recessions or financial crises.
The reasons for the non-existence of a market for insurance against labor market risk have to do with adverse selection, moral hazard, and covariant risk problems that plague any kind of insurance, but may be more acute in this particular case. We can explain them as follows.

**Adverse Selection:** If individuals buy unemployment insurance (UI), then it is possible that only those who intend to quit their jobs will buy insurance, and knowing this, the private sector would be reluctant to provide insurance. However, this argument may not be strong enough in many contexts, such as in the United States, because UI benefits are given only to those who have been laid off and not those who quit or were fired. In any case, verifying whether a person has quit or been laid off could be costlier for the private sector lacking a comprehensive administrative machinery. There could also be adverse selection on the part of firms buying UI. Only those firms which are likely to face high turnover may buy UI. Again, knowing this, the private sector would be reluctant to provide insurance.

**Moral Hazard:** People with UI may have fewer incentives to look for jobs while they are getting their benefits. Having UI increases the opportunity costs of finding a new job.

**Covariant Risk:** Probably the single most important reason for the non-existence of a market for UI is that unlike health, fire, auto insurance etc. where the shocks are idiosyncratic, UI has to deal with aggregate (non-diversifiable) shocks during recessions or financial crises, as in the case of East Asia. A large aggregate shock can result in huge claims bankrupting private providers of UI.

### 2.2. Externality-related arguments for social protection

Having discussed the reasons for the non-existence of private insurance against labor market risk which itself is a rationale for providing social insurance, we look at some other rationale for providing social insurance which would be relevant even if a private market existed.

One of the arguments for social protection is based on the possibility of labor-market crowding arising from adverse shocks. In a sector adversely affected by import competition, the lay-off decision by a firm leads to an increase in the pool of the unemployed or people searching for jobs. At the point of impact, this decision reduces the matching probability for
every worker searching for a job. This is an externality that is not internalized by anyone and so leads to labor market congestion. An adjustment subsidy can reduce the number of searchers or reduce search intensity and therefore ease this labor-market congestion (See for instance Aho and Bayard, 1984).

Barry (1995) has a slightly different argument. A sector in which a union operates has fewer than optimal number of layoffs as a result of import competition or a negative price shock. The reason is that the union tries to protect employment and reductions in employment have to be bought from the union for higher wages. Thus, the optimal transfer of workers from the declining to the expanding sector does not take place. Therefore, government financing of severance payments might aid in taking the intersectoral transfer of labor closer to the optimum.

Riordan and Staiger (1993) have an argument along similar lines. When a trade shock negatively hits an industry, it lays off some of its workers. These workers are the ones that are the lowest in quality among the workers it was employing. The higher quality workers are retained. The larger the shock, the better would be the average quality of the pool of workers laid off. Potential employers in the expanding sectors will not know the true quality of each worker laid off but know the average quality of laid off workers. A large shock leads to an increase in the quality of the pool of laid off workers and in turn leads to an increase in the inducement for firms in the expanding or the “favored “ sector to hire from this pool. This is a positive externality of layoff decisions of a declining sector firm on the favored sector and is not internalized in the absence of any policy intervention. Therefore, there are too few layoffs. Adjustment assistance to workers leaving employment in the declining or injured sector can help with internalizing this externality.

Among other reasons, there could be a positive externality resulting from efficient job matches. If workers devote time and resources to job search, the match can be better for both the firm and the worker. However, job search is costly and in the absence of a complete market for credit, a case can be made for the public provision of UI. It is unlikely that an unemployed worker can get too much credit while searching for a good job. Therefore, subsidizing job search by the unemployed through UI would increase social welfare.
Finally, UI can be an automatic stabilizer during recessions by propping up demand through income support to the unemployed. This argument is based on the fact that downturns are caused by insufficient aggregate demand. However, if they are caused by the productivity shocks as in the Real Business Cycle literature, then UI could decrease efficiency.

2.3. Distributional Equity Based Argument for Social protection

Globalization has distributional effects. Even when there are no costs associated with the mobility of workers from one sector to another or from one region to another, globalization can create winners and losers at the same time. For example, let us say factors can broadly be divided into two categories, say capital and labor and they are both mobile. International trade will benefit one of these two factors and hurt the other: The abundant factor gains and the scarce factor loses. If we introduce equilibrium search unemployment, the prediction from a Heckscher-Ohlin type of a model is that the unemployment rate of labor could go down in a country abundant in labor (developing country) and could go up in a country abundant in capital as a result of trade (See for instance Dutt, Mitra and Ranjan, 2009).

Work by Kletzer (2001) for the US shows that an average worker experiences a life-time income loss of $80,000 from displacement due to import competition. In addition, survey evidence shows that short spells of unemployment have extreme longer-term scarring effects (Davidson, Matusz and Nelson, 2010). A state of unemployment is considered by many who have experienced it as more traumatic than separation or divorce (Helliwell, 2003). Thus, normal inequality measures serve only as a lower bound on the extent of the lack of equity in society.

Recent work by Bardhan (2010) argues that income inequality has risen during the period of liberalized trade in India and China, despite the fact that poverty has fallen in these countries at the same time (See Bardhan (2010) and Hasan, Mitra and Ural (2007)).

1 Autor (2010) discusses the recent polarization of job opportunities in the US in the sense that expansion of opportunities is taking place in high-wage and low-wage employment with middle-wage job opportunities suffering a contraction. Autor argues that international trade in the form of offshoring is a major contributor to this polarization.
addition, Ahsan and Mitra (2010) find that trade reforms have reduced the share of wages in output.

While there is evidence that greater trade openness leads to lower steady state unemployment rates, there is also evidence that the short run impact effect of trade liberalization is an increase in the unemployment rate, which is followed by a reduction in the steady state unemployment rate (See Dutt, Mitra and Ranjan, 2009). The reason for that comes from search unemployment theory with endogenous job destruction and creation (Pissarides, 2000). This can be explained as follows. Trade liberalization unleashes forces that lead to the shrinkage of the import competing sectors and almost instantaneously leads to the destruction of jobs in those sectors. At the same time, it promotes the expansion of export sectors. However, jobs take time to be created there. This leads to an increase in the overall unemployment rate in the interim.

Based on the above evidence and arguments above, it is important from the point of view of social equity to have a program of social protection in place. This will counter increases in income inequality as well as the additional scarring effects of unemployment in addition to providing insurance against labor market risk.

2.4. Social protection makes globalization politically more palatable

As discussed earlier, trade liberalization benefits the abundant factor and hurts the scarce factor of production. Let us consider the simple case in which the majority are workers (even though the country can be labor- or capital-abundant). Then in a capital-abundant (rich) country, the majority loses from opening up to trade, even though aggregate welfare increases. Thus the majority can block reforms in such a situation. The question is whether compensation of workers (where they are made just a tiny bit better off than their pre-reform situation), say through some kind of lump sum redistribution, by capitalists can lead to a vote for reforms. It is important to note that if we take as given that compensation will take place, then everyone will vote for reforms as nobody now loses from reforms. Now, if there is a vote on whether workers should be compensated or not by capitalists, the majority will always vote for it, irrespective of the order in which the two votes (the one on
reforms and other on compensation) take place. Thus with this economic structure, we are going to get reforms if both reforms and compensation are democratically determined.

Most of the social protection programs target displaced workers. In that case, only workers who get displaced from their current job as a result of trade reforms get compensated. This can create problems as has been pointed out by Davidson, Matusz and Nelson (2007). To see their argument, suppose the political support of those who get displaced as a result of reforms is crucial for any reform to go through. In the absence of their support, the winners from reforms do not have enough votes to get the reform through. Now, if the vote on compensation takes place before the vote on reforms, then all those who gain from reforms vote for the compensation in addition to those who expect to be compensated. Subsequently, these voters vote for the reform as well. On the other hand, if the vote on compensation takes place after the vote on reform, then those who stand to gain from reforms do not have an incentive to vote for the compensation given that the vote for the reform has already taken place. In that case, the vote for compensation fails and anticipating that, the vote for reforms fails as well. In other words, if compensation is going to be only for displaced workers, societies should agree on compensation beforehand. (Note that, in this case, the majority of the people lose from reforms in the absence of any compensation, even though gainers gain more than what losers lose.)

The above logic can also hold when all movers benefit and the majority gain from reforms, but there is uncertainty about who ends up moving. In the words of Fernandez and Rodrik (1991), there is “individual-specific uncertainty” regarding who ends up moving and who ends up staying in the import-competiting sector upon reforms. Let’s say all those who are in the export sector prior to reforms gain from reforms. Let’s assume 40 percent of the population is in that sector to begin with. After reforms, this sector will have 70 percent of the population. Each mover will gain x and each person stuck in the import-competiting sector will lose y. Let us assume y > x, in which case prior to reform, any producer in the import-competiting sector initially views her expected change in welfare as 0.5(x-y) < 0. Thus, we get a vote against the reform ex ante even if ex post a majority of the people benefit. If movers are promised compensation such that x plus the compensation is a little more than y, then the compensation wins the vote if it takes place prior to the vote on reform and if
we assume that the winners (the people in the export sector to begin with) are still better off after the compensation. Following this a majority will vote for reforms. If a vote on compensation is taken after reforms, then the majority will vote against compensation. This negative majority vote, conditional on trade reforms, on compensation will be taken into account when a vote on reforms is taken in a prior stage. Thus, in this case, there will be a negative vote on reforms.

Thus just the possibility of compensation does not ensure making reforms politically more feasible. Some commitment to a principle of compensation to those vulnerable to shocks in general might be required to make trade reforms politically more palatable and feasible. Also, most kinds of social protection are for displaced workers. An example of that is Trade Adjustment Assistance (TAA) in the US. However, extending protection to workers stuck and employed in declining sectors might help with gathering support for trade reforms.

Brander and Spencer (1994) suggest that trade adjustment assistance may have a special role as a mechanism for weakening the political attractiveness of protection. Their argument follows similar arguments made by Bhagwati (1989) earlier. Magee (2003) has examined such arguments in a model of endogenous protection in the presence of TAA. He finds two opposing effects. Firstly, trade adjustment assistance subsidizes exit from the import-competing sector, which makes the sector smaller than what it would be in its absence. Thus, it reduces this sector’s lobbying strength. However, a smaller import-competing sector also means a smaller production distortion cost for the government of providing protection, thereby affording a higher level of protection. Thus, if the second effect dominates, the tariff might actually increase. In a model with endogenous tariffs and trade adjustment assistance, Magee actually shows that tariffs and trade adjustment assistance could be complements. He argues, “A large tariff requires a generous adjustment subsidy in order to pull workers out of the import-competing industry and offset the tariff’s production distortion. A large adjustment subsidy creates an incentive to keep the tariff high and maintain employment in the import-competing industry.”

We next examine whether providing compensation to displaced workers makes trade agreements self-enforcing and increases their sustainability. Here we outline and try to
simplify the argument made by Fung and Staiger (1994). Consider two countries that enter into a trade agreement to lower their tariff with a trade adjustment assistance built into it. Each country has an incentive to increase its tariff as it improves its terms of trade. However, each country’s trade adjustment assistance program reduces this incentive for its partner country. The reason is that the trade adjustment assistance promotes the expansion of the export sector (and the contraction of the import-competing sector) in each country. This makes the production structure of the two countries more different from each other and increases possible gains from trade (and reduces the gains from tariffs). Basically, the size of the potential market for exporters in each country grows in the partner country. Thus trade adjustment assistance sustains lower reciprocal tariffs, i.e., can lead to reciprocal trade liberalization.

Thus, social protection can potentially lead to freer trade. However, one needs to be careful in making this argument. Firstly, the decision on social protection will have to be finalized prior to carrying out trade reforms. Secondly, apart from displaced workers, workers stuck in a declining sector may also have to be provided with transfer to win their support for trade liberalization. Finally, countries that enter into a trade agreement with a trade adjustment assistance scheme built in have a better chance of being reciprocally able to liberalize trade.

Having seen the usefulness of compensation schemes in providing political support for globalization, we next look at some compensation schemes that can make reforms Pareto improving (ensuring that at least some people gain while no one loses) and thus have a normative appeal. In this context, it is appropriate to mention the seminal work of Dixit and Norman (1980). They had argued that if lump sum compensation can be provided (and lump sum taxes can be levied) to ensure that at the free trade commodity and factor prices each individual consumes his or her autarky consumption vector, then the government collects positive net revenues. Therefore, if these net revenues are returned to consumers on a lump sum basis, trade leads to higher welfare. Alternatively, commodity and factor taxes and subsidies (that maintain autarky commodity and factor prices faced by consumers), which require much less individual-level information, also lead to positive net revenues.
Feenstra (2004) has argued that there are several problems with the Dixit-Norman schemes when factor supplies are not perfectly inelastic resulting in imperfectly observable factor supplies and factor prices. Also, as argued by Feenstra and Lewis (1994), the real challenge comes when there are worker mobility costs. Then, if industries have fixed locations, factor and commodity taxes and subsidies will not work as workers will stay put where they were at initial wages and prices. An additional employment relocation subsidy, which is very similar to trade adjustment assistance (TAA), however, will do the job.²

Before concluding this section, it is worth re-iterating that globalization, in the form of trade liberalization or capital account liberalization or immigration, can be a source of increased volatility in open economies. Therefore, in the absence of a strong social protection regime, the political support for globalization can become weak or there could even be a backlash against globalization. This makes it imperative to provide strong social protection in open economies. However, according to Tanzi (2002), forces of globalization themselves may reduce a state’s capacity to provide social protection. Increased foreign competition can reduce the capacity of states to raise tax revenues. Countries with higher tax burdens will see capital and skilled labor flee to other countries with lower taxes. As well, technological progress in the form of e-commerce and by allowing many products that had a tangible form earlier, such as travel services, banking, education, medical advice etc., to be delivered over the internet and therefore not leave any paper trail, reduces the ability of states to collect excise, sales taxes etc. Finally, since people can take their savings abroad, it becomes difficult to tax wealth. Lower tax revenues, in turn, constrain the abilities of states to provide social protection.

3. Social Protection measures used to deal with the East Asian Financial Crisis

² It is important to note that Davidson and Matusz (2006) make an argument where they do not exactly side with Feenstra and Lewis. They argue that an employment (relocation) subsidy should be given to stayers (in the shrinking sector(s)) while a wage subsidy should be given to movers (to the expanding sector(s)). Brander and Spencer (1994) find that when the cost of raising revenue is high, TAA conditional on employment status is better despite their resource-use distortion. When people value their leisure arising out of unemployment relatively highly (or the scarring effect of unemployment is relatively low) and the distribution of wage offers across actual and potential employees in the new open trade situation is denser at somewhat higher wages, the relative attractiveness of the unconditional program is higher to the government.
We next turn our attention to some actual social protection measures to deal with the consequences of globalization and we start with East Asia. As mentioned before, trade liberalization is an important component of globalization. Another component of globalization is capital account liberalization, whose wisdom has been questioned by many prominent economists (See for instance Bhagwati, 2004 and Krugman, 1998). However, there are sometimes strong internal and external pressures to bring about such liberalization. And if capital account liberalization has already taken place, there is pressure not to reverse it. This is illustrated by the fact that of all the Asian countries hurt by the financial crisis of the late 1990s (the financial crisis itself being a result of free short-term international capital flows), only Malyasia ended up imposing capital controls through a system of selective exchange rate controls. The very fact that there is difference of opinion and not a consensus on this issue, with some prominent people also supporting capital account liberalization, makes it clear that there will be a lot of variation across countries in their ability to impose capital controls. However, if crises do result from capital account liberalizations, appropriate social protection measures need to be in place.

The crisis that began in July 1997 in Thailand quickly spread to the rest of East Asia. The decrease in GDP in 1998 was as follows (Betcherman and Islam (2001)): 0.4% in Philippines, 5.8% in Korea, 7.5% in Malaysia, 10% in Thailand and 13.7% in Indonesia. In addition, from 1996 to 1998, in the Philippines, the unemployment rate went up from 8.6 to 10.1 percent, in Korea from 2 to 6.8 percent, in Malaysia 2.6 to 4 percent, in Thailand from 2 to 5.2 percent and in Indonesia from 4.9 to 5.5 percent. Besides, there was a significant increase in underemployment as well. During 1997-98, underemployment increased by 29.2% in Korea and by 33.3% in Thailand. In other countries, the increase was smaller. Given the magnitude of the crisis, all the countries adopted social protection measures to mitigate its impact.

3.1. Unemployment Insurance

Korea was the only East Asian country with a program of UI at the time of crisis. Even there the program had started in 1995, only a couple of years before the crisis. The program was initially limited to firms with more than 30 employees, but the coverage was extended to businesses with more than 10 employees in January 1998 and to businesses with more than 5 employees in March 1998 and was extended to businesses with less than 5 employees in
October, 1998. However, the eligibility requirement that a worker must have been insured for at least 6 months in the 12 month period prior to the dismissal meant that only a few of the unemployed actually benefited from the program. In August 1999, only 12.3% of the unemployed received unemployment benefits (Kang et al. (2001)).

3.2. Employment Protection (EP)

All countries in East Asia had some types of EP in place at the time of crisis. In particular, all countries had some kind of firing restriction(s). In Indonesia, dismissals had to be approved by a tripartite committee. In Malaysia, Philippines and Thailand, advance notice of dismissal was required. In Korea, dismissal article was enacted in February 1998 and was to be enforced from 1999.

These countries also required severance payments in case of dismissal. Also, in Korea and Malaysia laws were amended during the crisis to make the severance pay available to employees leaving their jobs under voluntary separation. However, compliance was a problem, particularly in Thailand among small employers (Mahmood and Aryah 2001). In Malaysia only 83% of the claims were paid in 1998 (Mansor et al. (2001)). To alleviate the problem of non-compliance arising from bankruptcy, Korea and Thailand introduced guarantee funds to pay these workers.

There are no quantitative analyses of the impact of these employment protection measures on reducing job destruction during the financial crisis, but evidence from developed countries provided in Messina and Vallanti (2007) suggests that they are likely to have reduced job destruction.

Another employment protection instrument, less common in developed countries except for Japan, was wage subsidies. In Korea, wage subsidies were given under the Employment Stabilization Scheme which was a component of the comprehensive Employment Insurance System established in 1995 of which UI was a part as well (Kang et al. (2001)). Hiring subsidies were given to employers who hired laid off workers from restructuring enterprises. Employment maintenance subsidies were given to firms that retained redundant workers during times of temporary financial difficulty. An enterprise survey done during the crisis suggests that 22% of the subsidized jobs would have been lost in the
absence of wage subsidies. Also, the impact on employment maintenance was larger in smaller firms. Since only 1% of private employers participated in the wage subsidy program, the impact of the program on protecting jobs was minimal (see Kang et al. for further details). In Malaysia, there were no explicit wage subsidies but the government agreed to bear the full cost of training of workers from registered employers at government approved training centers. The government also made some recommendations like pay cuts, temporary layoffs, voluntary separation schemes etc. Employers preferred voluntary separations rather than pay cuts or temporary layoffs.

It is worth mentioning that these employment protection measures affected only workers in the formal sector of the economy.

3.3. Public Works Programs

All East Asian countries launched massive public works programs to transfer income to the large number of unemployed during the financial crisis (Betcherman and Islam 2001). In Indonesia these programs were expected to generate 300 million person days of work in 1998. In Korea, they generated 440000 jobs in 1998 and 1.2 million jobs in 1999. This provided work to 70% of the country’s unemployed in 1999. In Malaysia the government undertook several huge infrastructural projects like railroads, ports, highways etc. during 1996-98. These public projects were given special attention during the period of financial crisis because of their importance in income transfer to the poor. In the Philippines the government launched the 14 million pesos pilot Rural Works Program in collaboration with NGOs. This program engaged in building rural infrastructure such as schools, roads, bridges, health clinics etc. The government in Thailand undertook 68 rural job creation projects to improve rural infrastructure and provide income support to the poor in addition to encouraging reverse migration from cities to villages.

While the imperatives of launching a public works program during times of crisis are obvious in societies lacking other social protection measures such as unemployment benefits, designing them appropriately to meet the twin targets of asset creation and income transfer to the targeted groups is not easy. Setting the wage right can result in self-targeting. However, in the case of East Asia wages were set high resulting in these programs attracting
non-poor and people employed elsewhere, thereby reducing the net benefit from these programs. The project selection in many cases- such as construction work or project site far from the village- meant that women could not participate in these programs. Korea was an exception where women accounted for 50% of the participants in the public works program in 1999. In Indonesia many of the projects were not labor intensive enough with the wage bill accounting for a small part of the total project cost. However, these programs were still more efficient than some alternative ways to transfer income to the poor. For example, the cost of Indonesia’s rice subsidy program was much larger than their public works programs for each dollar of transfer (Betcherman and Islam (2001).

In addition to the above programs, some temporary measures used included the permission by the governments in Indonesia, Malaysia, and Thailand to allow people to withdraw money from their provident funds to smooth consumption during the crisis. In Korea and Philippines emergency loans were made available to people affected by the crisis. In the absence of borrowing opportunities from banks, such ad hoc measures played an important role in cushioning the blow from the financial crisis on consumption.

The bottom line is that even though East Asian countries used a variety of policy measures to mitigate the consequences of the crisis, probably, the single most important measure was the Public Works Program given the large size of the informal sector in most of these countries. Additionally, this is also consistent with an important feature of the development strategy in East Asia which relies on public investment in infrastructure. Public works may also be preferred because they tend to have a smaller leakage into imports and therefore have a high fiscal multiplier. As these economies develop more and the size of the informal sector shrinks, they can move towards social protection instruments used in developed countries, something that we describe in detail later. One important point to note here is that in East Asian countries there has been considerable reliance on self insurance based on their high personal saving rates, that are encouraged by their governments as part of their overall development strategy. In addition, East Asian countries also have a high rate of government saving, including foreign exchange reserves. This has been a protection strategy adopted by these governments since the Asian financial crisis. In the addition, the high
degree of flexibility of all markets, including labor markets, is considered by some to add to the resilience of East Asian economies to the various types of external shocks.\textsuperscript{3}

4. Social Protection Plans and their financing in Developed and Developing Countries

We now move away from the specific case of East Asia where, importantly, countries were subjected to a huge negative shock in the recent past, and look at the social protection measures more generally. In the developed countries the social protection measures used can be classified into the following categories:\textsuperscript{4} (1) Unemployment Insurance; (2) Employment Protection; (3) Public Works Program; (4) Trade Adjustment Assistance Programs. Apart from Trade Adjustment Assistance programs, the other three have been used to different degrees in developing countries (discussed earlier in the case of East Asia).

4.1. Unemployment Insurance

Virtually all developed countries have publicly provided unemployment insurance (UI) programs. These programs try to alleviate the adverse selection problems by making membership compulsory, and reduce moral hazard through the effective monitoring of job search activities by the beneficiaries and the use of information from other public programs to verify eligibility and other details. Finally, the government financial guarantee takes care of the covariant risk or the aggregate shock problem.

Below we describe in some detail the UI program in the U.S. and note how some key features of programs in other countries differ from the U.S. program (the discussion of UI in the US draws upon Meyer (2002)).

4.1.1. UI within the US

Approximately 97% of wage and salaried workers are in jobs covered by UI. Not covered are self employed, employees of small farms, and household employees. Despite this, only 40% of unemployed received UI in many years primarily because they failed to meet the minimum earning requirement. The program details vary considerably across states in the

\textsuperscript{3} The points about the role of high saving rates and flexible labor markets were brought to our attention by an anonymous referee.

\textsuperscript{4} Vodopivec (2004) provides a comprehensive discussion of income support measures. Our discussion of these programs draws upon Vodopivec (2004) in addition to the other sources mentioned throughout the text.
The benefits are usually between 50-60% of the previous earnings subject to a maximum and a minimum and they usually last up to 26 weeks. When a state’s insured unemployment rate is sufficiently high, weeks of benefits are extended 50% beyond the eligibility under the state law. The extension must not exceed 13 weeks. During times of high unemployment, Congress passes laws to temporarily extend the benefits.

**Financing:** The UI programs in the U.S. are financed by contributions from the employers. A federal levy of 6.2% is imposed on the first $7000 in wages a year per employee. A credit of 5.4% is given to employers that pay state taxes under an approved UI system, so that all employers pay 0.8%. 40 states have a tax base higher than the federal base of $7000. In 1998, UI taxes were 1.9% of taxable wages and 0.6% of total wages.

The most distinguishing feature of the UI in the U.S. is the use of experience rated contribution whereby a firm’s tax rate depends on its lay-off history. The experience rating system is not uniform across states but takes two common forms: 1) Reserve Ratio (30 states and the District of Columbia); 2) Benefit ratio (17 states). Under the Reserve Ratio, a firm’s tax rate depends on the difference between taxes paid and benefits accrued divided by average covered payroll. Taxes paid and benefits accrued are summed up over the past three years while the average payroll is the average of last 3 years. Under the Benefits Ratio, a firm’s tax rate depends on the ratio of benefits paid to taxable wages, both averaged over last three years.

Even though a firm’s tax rate changes with these ratios, however, tax rates do not adjust sufficiently to make the firm bear the full marginal UI cost of laying off a worker. There are large ranges at the top and bottom where a firm’s layoff history does not affect its tax rate. This in effect subsidizes industries with greater turnover.

In terms of financing, the U.S. experience rating seems to be an exception rather than the norm. In addition to making the employers bear the marginal UI cost of layoffs, an additional benefit of experience rating is that employers have an incentive to enforce eligibility rules because higher UI benefits accrued to their former employees is going to raise their tax rate. For example, in Canada an unemployed individual is three and a half times more likely to receive UI than in the US. This is partly due to the fact that those who
have left their previous jobs are not eligible in the US, but often eligible in Canada. However, part of the explanation has to do with the fact that without experience rating in Canada, employers have less incentive to enforce eligibility rules. That is, experience rating not only reduces layoffs by making firms bear the marginal cost of UI due to layoffs, but also reduces moral hazard by incentivizing firms to enforce eligibility rules.

The impact of experience rating on unemployment is theoretically ambiguous because it is likely to reduce both layoffs and hiring. That is, experience rating reduces both flows into and out of unemployment. In Europe the employment protection legislation may be playing the role of experience rating by reducing job flows and conversely, in the US experience rating may be playing the role of employment protection in reducing job flows.

Whether the employers or the workers should finance UI is another question worth asking. In general, the incidence of a payroll tax to finance UI depends on the elasticities of demand and supply for labor. Therefore, if demand is elastic then employers can shift the burden on employees. However, wage setting institutions seem to matter in determining the impact of UI on employment and unemployment. If wages are inflexible downwards, as in the case of decentralized collective bargaining, then making the employers contribute can reduce labor demand and employment.

4.1.2. UI outside the United States

Outside the U.S. benefits are usually in the range of 40-75% of the previous earnings. Denmark is an exception with a replacement rate of 90%. Ireland, France and the U.K. provide benefits at a flat rate. In the U.K. it is set at a very low level: $77 per week in 2000 (a quarter of the typical maximum benefit in the US), however, additional benefits are paid to workers with families. The maximum entitlement period varies considerably across countries usually in the range of 3-12 months. In Belgium the duration is unlimited while in France it is capped at 60 months. In most countries the program is financed by contributions from both employers and employees, but there are exceptions. In Italy, Iceland and the U.S. only employers contribute while in Luxembourg only employees contribute.

Outside the group of OECD countries, all East European countries, several Latin American countries such as Argentina, Brazil, and Barbados, and some East Asian countries such as
Korea, Taiwan and China provide UI. Among African countries, Algeria, Egypt and South Africa provide UI.

4.1.3. Empirical evidence on the impact of UI

Since the chief goal of UI is consumption smoothing, its effectiveness should be judged primarily in those terms. Gruber (1997) finds a large consumption smoothing role for UI in the U.S.: a 10 percentage point rise in the replacement rate reduces the fall in food consumption upon unemployment by 2.65%. Bentolila and Ichino (2001) provide evidence on the consumption smoothing effects of UI using data from USA, UK, Germany, Italy and Spain. They find that consumption falls less with unemployment in Italy and Spain because of more extensive transfers from family members.

In a study that has implications for social protection policies in developing countries, Chetty and Looney (2007) find that there is a 10% decrease in consumption in response to unemployment for both the U.S. and Indonesia. While the U.S. has UI, Indonesia does not. This may suggest that not much can be gained by providing social insurance in Indonesia, however, this would be wrong. The reason is that households in Indonesia use coping mechanisms which are costly from the welfare point of view. They reduce investment in the education of their children and increase the labor supply of other members of household when the head of the household becomes unemployed. In contrast, in the U.S. consumption smoothing is attained through UI benefits, decline in tax burden, and withdrawal from savings.

While UI succeeds in its role of consumption smoothing, it also has a downside in terms of increase in unemployment (see Nickell (1998) for evidence). A recent influential paper, Chetty (2008), finds that the bulk of the rise in unemployment duration due to increased UI benefits comes from a liquidity effect (60%) rather than moral hazard. That is, an increase in UI eases the liquidity constraint of the households which allows them to reduce their search intensity and hence increases unemployment duration. Intuitively, in the presence of liquidity constraints, the search intensity of households is above optimal (it is probably too large). Therefore, UI takes it closer to the optimal by relaxing the liquidity constraint and hence is welfare improving. Chetty also derives a formula for optimal UI benefits and finds it
to be in excess of 50% of the wage. Empirically, he identifies the liquidity effect from the fact that the increase in UI benefits has a much larger effect on the duration of liquidity constrained households. Second, lump sum severance payments (which presumably do not lower the returns from job search) increase duration substantially among constrained households.

Some fear that UI crowds out savings for self-insurance purposes. Engen and Gruber (2001) find that more generous UI leads to lower savings, however, the magnitude is very small. The above points to the fact that there is little saving for self-insurance purposes.\(^5\)

### 4.1.4 Unemployment Insurance Savings Account (UISA)

Several Latin American countries such as Argentina, Brazil, Chile, Colombia, Ecuador, Peru, Panama, Uruguay and Venezuela have introduced UISA or versions of it (see Ferrer and Riddell (2009) for an overview of UISA). In its purest form, UISA is like a mandatory saving program for self-insurance purposes whereby employers put aside a part of the wages of a worker in an account which the worker can access upon separation from the job. The key benefit of UISA is that it overcomes the moral hazard problem associated with the traditional UI programs of lowering the incentive for job search. This could be an advantage in countries with limited monitoring capacity to monitor the unemployed. Both UISA and severance pay avoid the moral hazard on the part of workers. However, an unfunded severance pay program can lead to moral hazard on the part of firms in turn leading to non-compliance (as in the case of Peru to be discussed later). UISA can potentially avoid this kind of moral hazard on the part of firms by keeping the contributions in accounts with third party financial institutions. Therefore, UISA can be a substitute for severance pay programs as was done in Colombia in 1990. However, UISA may lead to excessive turnover by encouraging workers to separate to access their funds as has been observed in Brazil.

\(^5\) While inequality has been growing in the U.S. over the last couple of decades, UI is not the right instrument for attacking this problem. An instrument, such as a progressive income tax, that more directly targets this objective, is more efficient in this regard.
The main weakness of UISA is that it involves intertemporal risk pooling for an individual rather than pooling risks across individuals which is one of the key motives behind a traditional UI program. It is easy to see that self-insurance would result in too little saving for consumption smoothing during unemployment. Therefore, UISA cannot be a substitute for the traditional UI program. There are versions of UISA that combine some social insurance features with self-insurance. One such version is the UISA combined with a solidarity fund in Chile which has come for some praise. In this case the employers contribute to both UISA and a solidarity fund which pools risk across the economy. Once individuals run out of funds in their UISA account, they get money from the solidarity fund.

4.2. Employment Protection

This refers to all the restrictions that governments impose on hiring (e.g. rules favoring disadvantaged groups, conditions for using temporary or fixed-term contracts, training requirements) and firing (e.g. redundancy procedures, mandated pre-notification periods and severance payments, special requirements for collective dismissals) by firms with the objective of improving job security. Most developed and developing countries have a host of such restrictions. The OECD compiles an index of Employment Protection Legislation (EPL) across countries. According to the latest OECD data available on stats.oecd.org, this index varies from a low of 0.21 in the U.S. to a high of 3.72 in Turkey in 2008. Among developing countries, the index takes the value of 2.65 for China, 2.75 for Brazil, 2.77 for India, and 3.68 for Indonesia.

Theoretical models such as Bentolila and Bertola (1990) show that stringent regulations reduce job flows but the impact on unemployment is ambiguous. Blanchard and Portugal (2001) contrast the EPL in Portugal (3.85 in 1995) with that in the US (0.21 in 1995). Despite having very different EPL regimes the two countries had similar unemployment rates in the 1990s. The difference in the EPL regimes shows up in employment flows. The flows out of unemployment into employment and that out of employment into unemployment are lower in Portugal. As a result, the duration of unemployment in Portugal tends to be higher than in the US.
Messina and Vallanti (2007), using data from 14 European countries, find a negative effect of employment protection legislation on job flows. They also find that stringent regulations reduce job turnovers during recessions.

One aspect of employment protection legislation, severance pay, refers to the lump sum payments made to workers upon separation. While severance pay is mandated in several countries, in others such as the U.S. it is provided voluntarily by many employers. Also, in many European countries such as Germany, Netherlands, and Switzerland, where severance pay is not mandated, it is provided through collective bargaining agreements. Severance pay is typically tied to the years of service with the employer and is financed by the employers. In addition to providing job security it also aims to provide consumption smoothing opportunities. MacIssac and Rama (2000) show that severance payments had a large effect in protecting the consumption of the unemployed in Peru. In the absence of severance payments, the per capita consumption of the unemployed fell 10 to 20%. However, the receipt of severance payment more than offset the decline in consumption. One problem with severance pay, particularly in developing countries, is non-compliance. For example, according to MacIssac and Rama (2000) in Peru only about half of workers who are entitled to receive severance pay actually receive them. Part of the problem arises from the fact that severance pay involves risk pooling only within the firm and additionally that liabilities arise usually when the firm is in financial trouble (as was the case during the East Asian financial crisis discussed below).

Finally, severance pay does not create the moral hazard associated with UI in terms of lower search intensity while being unemployed, however, it may create a moral hazard of entering unemployment. That is, workers may want to separate to access severance payments. This also may lead to large litigation costs arising from disputes related to the cause of separation. The reason is that in many countries such as Brazil eligibility is restricted to dismissals for unjustified reasons.

4.3. Public Works Programs

In countries lacking unemployment insurance, public works programs play an important means of providing social insurance. These programs are financed by governments from
general tax revenue. Some general principles to keep in mind while designing these programs are (Vodopivec (2004)): 1) foregone earnings should be minimized by attracting workers with low alternative earnings opportunities; 2) wages should be low enough to induce self-selection by the needy; 3) the non labor cost should be minimized.

While these programs are generally used to provide income support to the poor during times of economic and natural shocks, Ravallion (1999) argues for making well designed public works programs permanent to provide social insurance against covariant risks during crises and idiosyncratic risks during non-crisis times. It is interesting that following the success of the Maharashtra Employment Guarantee Scheme in India, the government launched an ambitious social protection plan under the name of National Rural Employment Guarantee Act (NREGA) in 2006. It guarantees a minimum of 100 days of employment to every household in rural areas in all districts of India. The wage cannot be less than the state minimum wage. The program has received positive reviews in several well governed states. As mentioned in the case of East Asia, India also needs to establish a UI scheme; however, it is unlikely to cover the large number of workers employed in the informal sector of the economy. Until then, public works programs like NREGA are going to remain an important instrument of social protection in developing countries like India.

4.4. Globalization Adjustment Programs

Given that globalization and import competition have become important issues for workers and workers’ unions, several countries have introduced social protection programs specifically to protect labor from policies promoting and shocks related to globalization.

4.4.1 Trade Adjustment Assistance (TAA) Program in the US

This is a program of social protection in the United States targeted towards workers affected by international trade[^6]. The reason for special treatment of workers affected by international trade has to do more with politics than economics. For reasons explained earlier in this paper, it is widely believed that the political support for trade liberalization would be enhanced if the workers adversely affected by such a move are compensated.

[^6]: See Rosen (2008) for the details of TAA in the U.S. as well as suggestions for strengthening it.
adequately. Since trade provides efficiency gains, redistributing some of the gains to those who are adversely affected also goes in the direction of enhancing distributional equity.

In order to be eligible for TAA, a worker must show that the job loss was due to at least one of the following reasons: an increase in imports; a shift in production to another country; or due to import competition faced by the downstream firm to which the worker’s upstream firm is a supplier. Workers eligible for TAA get the following benefits. 78 weeks of income maintenance payments, in addition to the initial 26 weeks of UI, if enrolled in training; all training expenses; health insurance tax credit; wage insurance which covers half the difference between the old wage and the new wage, subject to a cap of $10,000, for two years for workers older than 50; 90% of the cost of job search up to a cap of $1250; and 90% of the cost of relocation up to a cap of $1500. The program is financed from general revenue even though there has been a proposal for setting up a trust fund for a long time.

In addition to the TAA for workers, there is also a small TAA providing technical assistance to firms adversely affected by import competition and a TAA for farmer and fishermen which covers a part of the drop in their earnings due to a decline in the international price of their products.

4.4.2. European Globalization Adjustment Fund (EGF)

Set up by the European Union in 2006, the objective of the program is similar to the TAA in the U.S. in terms of assisting workers affected adversely by trade liberalization. To be eligible for assistance from this fund, a request must be made by a member state that at least 500 jobs have been lost in a firm or in a sector within a region due to changing world trade patterns. The fund provides support in the form of

- job-search assistance and training
- job-search allowances to individuals participating in lifelong learning and training activities.

Since its inception in 2007, the EGF has spent €67.6 million, helping 15000 workers. Some examples are: help to 2400 workers at the two German subsidiaries of mobile phone manufacturer BenQ because of shift in production to Asia; and help to workers working for
suppliers of car makers Renault and Peugeot in France facing increased competition from imports of small cars from Asia.

4.5. Other Social Protection Measures

In addition to the above programs, countries also use several other measures like unemployment assistance programs in Australia and New Zealand which are means-tested programs benefiting the poor. Another program worth mentioning is the Public Distribution System (PDS) in India which is a way of making some basic food items available at an affordable price. Since the economic reforms in the early 1990s, the PDS has become a safety net for the poor against the possible short run spikes in food prices in the wake of economic reforms and the forces of globalization. Since 1997, the PDS is being targeted towards people living below the poverty line and the subsidies for those above the poverty line are being phased out.

4.6 Some problems with social protection policies in developing countries

4.6.1 Problems with Labor Protection Laws

As we mention elsewhere in the paper, the main methods of offering protection to workers in developing countries are public works or infrastructure projects as well as labor market policies that put constraints on employers especially when it comes to laying off or firing workers. Labor market regulation has often been argued to be an important reason for the poor performance of the manufacturing sector in some developing countries, especially those in South Asia. (See for instance Besley and Burgess (2004) for India). While meant for protecting labor, they can adversely affect labor demand. For example, Chapter VB of India’s Industrial Disputes Act (IDA) requires employers with more than 100 workers to seek the prior government approval before the dismissal of any workers. In practice, governments

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7 For a critique of the Besely-Burgess index of labor-market rigidity, see Bhattacharjea (2006, 2010), where he also challenges the results obtained by Besley and Burgess (2004), showing them to be not robust to the addition of important controls including state-specific time trends and deletion of what he believes are irrelevant controls. Work by Hasan, Mitra and Ramaswamy (2007), Hasan, Mitra and Ural (2007), Mitra and Ural (2008), Hasan, Mitra, Ranjan and Ahsan (2011), which use various modification of the Besley-Burgess index (including incorporating some of Bhattacharjea’s criticisms and concerns) shows that labor-market flexibility in general magnifies the effects, irrespective of whether they are beneficial or adverse, of trade liberalization. Beneficial effects of trade reforms include those on poverty, unemployment, productivity, investment, employment etc, while harmful effects include increase in labor-demand elasticities that possibly leads to the decline in the bargaining power of workers (See Rodrik, 1997).
have often been unwilling to grant such permission (Datta-Chaudhuri, 1996). Therefore, critics argue that these laws have created a bias against hiring (abundant) labor relative to (scarce) capital, leading to weak employment growth (See Hasan, Mitra and Sundaram, 2010 for some cross-country evidence). Panagariya (2008) argues that restrictions on layoffs can prevent producers from attaining economic scales of production since firms may be reluctant to hire workers who they cannot fire or layoff in response to adverse shocks. Other restrictions, such as minimum wage laws, the rules governing collective bargaining etc, also meant to protect workers, may have similar effects. For example, with the Trade Union Act allowing multiple unions within the same establishment, a requirement of worker consent for say job description changes “can become one of consensus amongst all unions and groups, a virtual impossibility” (Anant, 2000).

Furthermore, since restrictive labor laws inhibit firms’ ability to adjust their employment of regular wage workers to demand and technology shocks like those arising from trade liberalization, firms can resort to hiring informal or casual workers often operating in inferior working conditions without basic labor protection, thereby defeating the very purpose of these employment protection laws. Goldberg and Pavcnik (2003) have provided evidence that in Colombia their ill-designed labor regulations have resulted in trade reforms leading to an increase in informal employment. Goldberg and Pavcnik (2003), however, find no evidence in the case of Brazil of any relationship between trade policy and informality in the presence of labor market regulations. Other papers showing the adverse effects of labor laws taking the form of an increase in informal employment in Colombia are Maloney and Mendez (2003), Arango and Pachon (2004) and Kugler and Kugler (2003). However, Maloney and Mendez (2003) and Arango and Pachon (2004) also show a decline in informal employment in Brazil that has accompanied the recent increase in the minimum wage there. A recent paper by Kucera and Roncolato (2008) surveys the theoretical literature as well as the empirical studies on the relationship between labor regulations and informal employment. Surveying various cross-country as well as intra-country studies, they conclude that “Some of the statistically strongest results in the literature show a positive relationship between the strength of labor regulations and shares of formal employment.........Most of the studies essentially show no relationship.” They, however, do not deny that some of the
studies also show a negative relationship between labor regulations and the formal employment share (positive relationship between labor regulations and the informal employment share). While their conclusion is that “the empirical evidence does not support the view that weakening labor regulations is an effective policy for reducing informal employment,” we cannot recommend, given fairly serious doubts regarding the effects of labor regulations, using them as a tool for social protection. In a recent cross-country study, Hasan, Mitra and Sundaram (2011) look at the determinants of three-digit industry-level capital intensities in formal manufacturing. They find that less restrictive labor regulations (after controlling for other relevant factors) are associated with lower capital-intensity. This is especially true in sectors that require more frequent labor adjustment. This suggests that stringent labor regulations can impose costs on labor use, thereby pushing firms towards greater capital intensity in labor-abundant developing countries, in turn reducing labor demand and curtailing gains from trade based on factor-abundance driven comparative advantage.

4.6.2. Public Works Programs

Finally, we discuss a couple of problems related to the financing of public works (infrastructure) projects that are used as a tool for social protection in developing countries. These public works projects can potentially be very important since they provide protection to workers outside the organized sector or the formal sector that forms a small part of the overall employment. These projects are financed by either income tax revenues or sometimes foreign aid including aid from international organizations. The first problem is that the tax collection machinery in developing countries is very weak. There are serious problems with tax evasion. Raising tax rates does not lead to higher revenues. In fact, it has been well documented that tax revenue could decline as a result of increasing tax rates as that triggers more evasion. Therefore, the size of public works programs as a source of worker protection remains limited as there are serious constraints on expanding them. In addition, corruption is a problem with public works projects. The objective of social protection cannot be viewed as totally divorced from other social objectives including the
control of corruption in developing countries. However, as pointed out earlier, these programs have proved to be more cost effective than some food subsidy programs.

5. Best practices with regard to social protection

As discussed earlier, in the developed countries, the two main instruments of social protection are unemployment insurance and employment protection measures. A liberal unemployment insurance regime creates moral hazard in terms of the search activities of the unemployed, while employment protection measures reduce the ability of firms to hire and fire workers, thereby creating misallocation of resources. Finding the right mix of policies to provide social protection is a tricky issue.

Sapir (2006) classifies European social protection systems into four groups: The Mediterranean model; the Nordic model; the Continental model; the Anglo Saxon model. The Mediterranean model combines parsimonious unemployment benefits with high employment protection while the Nordic model has generous unemployment benefits and low employment protection. The Continental model has generous unemployment benefits but lower employment protection than the Mediterranean countries while the Anglo Saxon model has very little employment protection but similar unemployment benefits. In terms of outcomes, the Nordic model achieves both equity and efficiency while the Mediterranean model achieves neither and is also fiscally unsustainable. The Continental model achieves equity but the efficiency is low while the Anglo-Saxon model achieves efficiency, but equity is low. Also, the public resentment against globalization is far more severe in the Continental and Mediterranean countries than in the Nordic and Anglo-Saxon countries (see Sapir (2006) for evidence). This combined with the low efficiency makes it imperative to reform the labor markets in the Continental and Mediterranean countries.

Given the superiority of the Nordic model in terms of outcomes such as poverty and employment rates, it has received closer scrutiny. In particular, the Danish “flexicurity” system which combines low employment protection with generous unemployment benefits has received a lot of positive attention. The labor market reforms in Denmark in the mid 1990s brought the EPL index down from 2.4 in 1994 to 1.5 in 1995 and it has remained at that level since then. To alleviate the moral hazard associated with generous unemployment
benefits, the government relies on the strict monitoring of the job search activity of the unemployed. Given the success of the Nordic model in achieving the twin objectives of equity and efficiency, other countries may be tempted to copy this approach; however, Cahuc and Algan (2006) argue that the success of the monitoring efforts in reducing moral hazard depends on the social norms in a country. Therefore, what works in Denmark with a strong public-spiritedness may not work in the Continental and Mediterranean European countries because of the lack of public-spiritedness in the latter.

It is important to note here that there is now a growing consensus across Europe in favor of a modified version of the original concept of “flexicurity” (See Spidla and Larcher, 2008). The European Commission takes an integrated approach and redefines flexicurity to consist of a set of “more flexible and secure contractual arrangements, from the point of view of both employer and worker.” It also wants to incorporate “lifelong learning strategies” so that people are better able to adapt to change and transitions. Also, transitions to new jobs need to be supported by effective labor market policies and modern social security systems. Just based on how it is being defined, there seems to be considerable flexibility in the design of the system and it is being emphasized that the actual design of it within any country or region should take into account cultural norms. While the European Commission has laid out “certain common principles of flexicurity,” there is no one single model. Whatever model is adopted by a region or country, it needs to be one that provides adequate flexibility to employers, especially in responding to the forces of globalization and at the same time should provide job security to employees. This implies support in job search, income support during transitions as well as provision of training opportunities helping to adapt to change. Also, a broader view of flexibility and security is taken. In other words, flexibility is not specific to employers and security is not specific to employees. For example employees may seek greater flexibility in reconciling work and family obligations, while employers might need more secure employment relationships through say legal security. Actual applications of this concept of flexicurity outside Denmark are in France where 36-month specific-purpose “mission contracts” have been introduced. At the end of the contract, depending on need and performance, a firm decides whether to convert the contract to an open-ended one. This provides the firm with more flexibility especially in
dealing with shocks such as greater import competition. Also in France, the national public employment service agency has been made in charge of unemployment insurance. That has made possible better monitoring and at the same time better services. Besides, the vocational training system is being reformed to aid better adjustment. In Poland, personalized jobseeker support is being provided and special assistance is being provided to older jobseekers. In Sweden, reforms such as reductions in social contributions, tax credits and medical and occupational rehabilitation schemes have been brought about to promote the employment of people who have been on long-term sick leave. This is intended to promote efficiency and growth. Compared to Denmark, employment protection laws are stronger in Sweden. In addition to what is captured in the EPL index, there is extra employment protection obtained through union contracts in Sweden. However, unemployment benefits are quite a bit higher in Denmark. Also, active labor market policies to help people cope with change are stronger and more prevalent in Denmark as compared to Sweden. However, Sweden provides better lifelong learning programs to reduce adjustment required in response to shocks. Thus, while flexicurity is present in both Denmark and Sweden, they are somewhat different from each other along its different dimensions (See Bergland and Furaker, 2010).

The U.S. model is closer to the Anglo-Saxon model in terms of employment protection but less generous in terms of unemployment benefits. These policies have kept the U.S. labor market flexible and since the duration of unemployment has been low, parsimonious unemployment benefit has not had a significant detrimental impact on the welfare of the unemployed. However, things have changed in the U.S. economy since the recession of 1990-91. Before the recession of 1990-91, output recovered to the pre-recession level within two quarters, and lost jobs were recovered eight months after the recession trough. In the 1990-91 recession, however, whereas production recovered within 3 quarters, it took 23 months from the trough of the recession to recover the lost jobs. After the 2001 recession, output recovered in just one quarter, but it took 38 months after the trough of the recession for all the lost jobs to recover. If the trend continues, the recovery from the current recession is likely to be even longer. These so called ‘jobless recoveries’ have meant

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8 These numbers are from Rajan (2010).
longer spells of unemployment which combined with a weak safety net are a recipe for political unrest. The problems for an unemployed person in the U.S. are compounded by the loss of medical insurance which is mainly employer provided while the private insurance remains unaffordable for most people. Responding to the crisis, the politicians in Washington, D.C. have extended unemployment benefits and enacted several *ad hoc* policies to spur job creation in addition to providing other types of fiscal stimulus. However, in the long-run rather than relying on discretionary spending during times of crises, it may be a good idea to strengthen the safety net by making the unemployment insurance program more generous and healthcare affordable.

In developing countries, we have noted that social insurance is constrained due to serious limits on the state’s ability to raise revenues. Evasion of direct and indirect taxes is a real problem. While there are problems of leakage and corruption with public works programs, the problems with other kinds of social protection systems are more severe in developing countries. Public works programs are also the best available means of alleviating poverty as food subsidy programs can potentially lead to more leakage, as has been seen in the Indonesian case. In addition, in developing countries, the large informal sector, the high incidence of poverty and the harmful effects of rigid labor laws regarding layoffs (and changes in job description) increase the attractiveness of public works programs. However, governments there need to find more innovative ways of raising revenues and probably should invest more in tax collection mechanisms that minimize evasion. Recent efforts in India to assign every citizen an identification number (just like social security numbers in advanced countries) are a significant step in that direction.

6. Concluding Remarks

In this chapter, we have discussed social insurance programs or other labor market interventions that allow people to deal with labor-market risk arising from shocks in general and external shocks in particular. We discuss here the main reasons for the need for social

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9 While the Medicaid program in the US is aimed at providing medical insurance to the poor, poverty by itself does not qualify one for these benefits. Other eligibility criteria regarding assets, age, pregnancy, disability, blindness, income and resources etc also have to be met.
protection. Those include the reduction of the political opposition to globalization, promotion of distributional equity, the absence of markets for unemployment insurance and the presence of labor-market inefficiency resulting from various externality-based market failures.

While we have made a case for social protection when workers are exposed and vulnerable to shocks in general, we have, in certain parts of the chapter, focused on shocks arising from globalization, a major part of which is driven by trade policy, something over which governments have some control. The question we have asked here is in the presence of what kinds of social protection in place, does freer trade lead to an improvement in the welfare of some without hurting anyone else in the economy? We additionally study the conditions under which social protection leads to greater political support for (or less opposition to) trade reforms. In this context, we also deal with the choice of social protection policy instruments.

We have also looked into the issue of the effectiveness of social protection policies in mitigating employment disruptions caused by globalization. We have done this in the context of the record of social protection systems in developed and developing countries, with special focus on how such systems in East Asia were able to deal with injuries to workers caused by the financial crisis of the late 1990s. While East Asian countries used a variety of policy measures to mitigate the consequences of the crisis, probably, the single most important measure was the Public Works Program given the large size of the informal sector in most of these countries. Unless the size of the informal sector shrinks (which will happen with development), developed country social protection instruments will not be that useful.

We have also examined different approaches to funding social protection systems, which vary, but not by much, across developed countries. The tax on firms to finance social protection ranges from flat to mildly progressive in the extent of turnover. In developing countries with underdeveloped income tax systems, mainly employment protection policies such as mandatory severance packages or labor laws are in place. Globalization or trade adjustment assistance programs are also not prevalent in developing countries.
Finally, we have discussed the “best practice” among governments. We discuss the different types of European social protection systems and come out in favor of the Nordic model which achieves both equity and efficiency at the same time. In particular, we draw attention to the Danish “flexicurity” system which combines generous unemployment benefits with strict monitoring of job search. We also discuss the recent modifications and redefinitions of “flexicurity” by the European Commission that emphasizes more flexibility in the model based on cultural and social norms. In developing countries, despite problems with leakage, given the large informal sector, the high incidence of poverty and the harmful effects of rigid labor laws regarding layoffs, public works programs are the best option. However, governments there need to invest in improving their income tax collection infrastructure to enhance tax compliance.

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