Notes on unemployment compensation programs in developing and emerging economies[1]

Should developing and emerging economies use unemployment compensation programmes (entailing both unemployment insurance and unemployment assistance) as a core element of their social protection policies? Critics usually contend that unemployment compensation (UC) programmes are not suitable for developing and emerging economies for a variety of reasons: they are not fiscally affordable; they lead to an increase in the incidence and duration of job search; they can be abused by recipients. The available literature that these concerns are exaggerated.

Wayne Vroman is the best source when discussing the viability and effectiveness of designing unemployment compensation (UC) programs for developing and emerging economies. In a well-known 1999 paper, written in the wake of the 1997 Asian financial crisis, he argued that most of the middle-income Asian economies would be able to operate an unemployment insurance program of 'average OECD generosity' using effective payroll tax rates of 1.0 to 2.0 per cent, with the former applicable to unemployment rates of about 4% and the latter to about 8%.[2] These estimates are also corroborated by an ILO study by Eddy Lee (1998).[3]

[1] Prepared by Yan Islam, Employment Policy Dept, ILO, Geneva, March 19, 2009

[2] Vroman, W (1999) 'Unemployment and unemployment insurance in three groups of countries', Social Protection Discussion Paper No.1911, May, Social Protection Unit, Human Development Network, The World Bank, Washington DC.

[3] Lee, E (1998)*The Asian Financial Crisis: The Challenge for Social Policy*, Geneva: ILO. Lee maintained, based on initial calculations, that it would be feasible to introduce unemployment-

In a subsequent update (2005) that he co-authored with Vera Brusentev, Vroman offered a comparative analysis of unemployment compensation programs throughout the world.[4] What strikes one is that, even several years after the 1997 crisis, the Asian economies are characterised by a dearth of UC programs. The study found that only six countries in Latin America the Caribbean have formal UC programs. Even then, they are typically modest in scale, of short duration and have low replacement rates. The attached graph highlights two emerging economies – Brazil and China – and compares the coverage of their UC programs with some members of the G7. The rather limited nature of UC programs in Brazil and China is quite evident (see Figure 1).

The key debate about UC programs in middle income developing and emerging economies is not really about fiscal affordability (as Vroman's broad estimates reported above suggests, such programs can be financed through reasonably modest payroll taxes), but about disincentive effects, most notably the view that UC programs induce higher incidence and longer duration of unemployment. In the case of Latin America and the Caribbean, UC programs usually failed to reach the intended beneficiaries. This, however, does not mean that UC programs are inevitably prone to such problems. As the long experience of designing and reforming UC programs in the OECD have shown, it is possible to make UC programs incentive-compatible in order to

insurance schemes for formal sector workers financed by contribution of 1 percent each from the payroll and the employer's contribution.

[4] Vroman, W and Brusentev, V (2005) *Unemployment Compensation Throughout the World: A Comparative Analysis*, Kalamazoo, Mich: W.E. Upjohn Institute for Employment Research

reduce the impact on the incidence and duration of unemployment and to make them better targeted.

One can also draw on the work of Raj Chetty, regarded by *The Economist* as a member of an elite group of young economists who are moulding the analytical and empirical frontiers of economics.[5] He re-interprets the debate on unemployment insurance (UI) in a way that bolsters the ILO's standard recommendation to use UI as an important instrument to mitigate labour market risks. [6]

The usual critique against UI is that it creates perverse incentives or a 'moral hazard' problem. As noted, one concern is that increases in unemployment benefits motivate workers to increase their duration of job search and thus contributes to an increase in both the length and incidence of unemployment. Policy design with respect to UI has focused on reducing the 'moral hazard' problem.

Chetty argues that the debate on UI has overlooked two channels via which this particular instrument of social protection motivates job search: (a) liquidity constraint; (b) moral hazard. Unemployed workers are often liquidity-constrained and are likely to become even more so during recessions. Thus, their consumption is highly sensitive to relaxation of the liquidity constraint. Increasing UI benefits and increasing their coverage enhances the

---

[5] *The Economist* (2009) `Bright Young Things`, Jan 39, pp.58-59

[6] Chetty, R (2008) 'Moral hazard vs. liquidity and optimal unemployment insurance' Working Paper 13967, *National Bureau of Economic Research*, Cambridge, MA

net welfare of unemployed workers, if the effects operating via (a) exceed the effects operating via (b). Empirically, this seems to be borne out.

Policy-makers in developing and emerging economies have tried to respond to the disincentive effects through restrictive statutory provisions and also to use other measures, such social investment funds (SIFs) and severance payments (SPs) as substitutes. Both these approaches have been ineffective. What one needs instead is a regime of active eligibility monitoring by requiring claimants to develop individual re-employment plans and by using employment offices with job-matching capabilities. Fraudulent use of benefits can also be reduced though electronic cross-checks. In sum, UC programs in developing and emerging economies require complementary investments in infrastructure that enhances the capacity of governments to undertake better targeting and reduce disincentive effects.

Another tendency among policy-makers is to regard such instruments as SIFs and SPs as substitutes for UC program. Yet, SIFs and SPs do not have a good track-record, especially in terms of coverage. In Bolivia, for example, the benefits of SIFs barely reached 1% of total employment in crisis years and 0.1% of employment in normal years. The evidence from Latin America and the Caribbean shows that SPs are ubiquitous. Yet, they reach about 20 per cent of the formal sector work-force and are likely to be received by those who are less likely to experience unemployment.[7] In Indonesia, SPs are now among the most generous in the developing world. This has led to a good deal of

[7] Vroman and Brusentev (op.cit)

debate about the deleterious consequences of labour market regulations.[8] The fallacy is to consider SPs as a substitute for UC programs. Instead, the latter and other elements of social protection should be seen as complements that, when creatively combined, enable workers in developing and emerging economies to have access to a range of risk-mitigation schemes.

Finally, it should be noted that global policy debates are influenced by the position adopted by the international financial institutions. Here, the Bretton Woods Institutions have generally steered clear of recommending UC programs. The emphasis seems to on elements of targeted social protection programs – such as conditional cash transfer programs, public-works employment and subsidization of the consumption of inferior goods - that focus on `bailing out the…poorest` households.[9] Given that the poorest households cannot afford to be unemployed, UC programs do not meet the test of social protection programs favoured by the Bretton Woods institutions. The position adopted here is that UC programs respond to a particular type of labour market risk and particular groups in society that cannot be met by other initiatives. To reiterate, one should adopt a holistic approach where UC programs complement other elements of a social protection package.

[8] Dhanani, S, Islam,I and Chowdhury A (2009) *The Indonesian Labour Market: Changes and Challenges,* London and New York: Routledge, Forthcoming
[9] Ravallion, M (2008) 'Bailing Out the World's Poorest', Washington DC: The World Bank

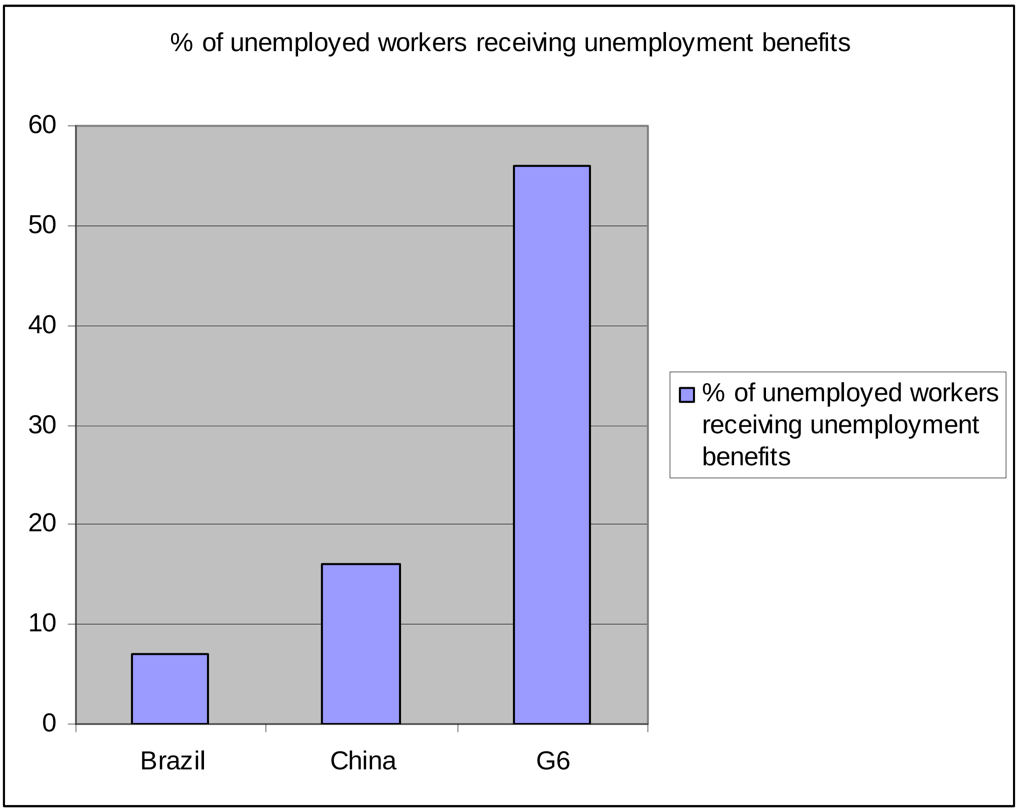

Figure 1

Source and notes: Derived from dataset created by International Institute of Labour Studies, Geneva.

'G6' refers to Japan, Canada, USA, UK, France and Germany