



Human Development *Network*

Designing Unemployment Benefits in Middle and Low Income Countries

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Outline

- Concerns with the implementation of unemployment insurance in MICs and LICs
- What do we know about the labor market impacts of *traditional* UI
- A possible design

Concerns

Labor market and fiscal concerns

- Labor supply:
 - UB can reduce incentives to search for jobs and accept job offers (raises wages and unemployment)
 - This effect can be particularly important when there are large informal sectors...
 - ... and weak institutional capacity to control abuse
 - The end result can be higher unemployment and potentially large fiscal outlays
- Labor demand:
 - UB would become yet another insurance program and contribute to increase the tax-wedge
 - A higher tax wedge can further reduce formal employment

Institutional concerns

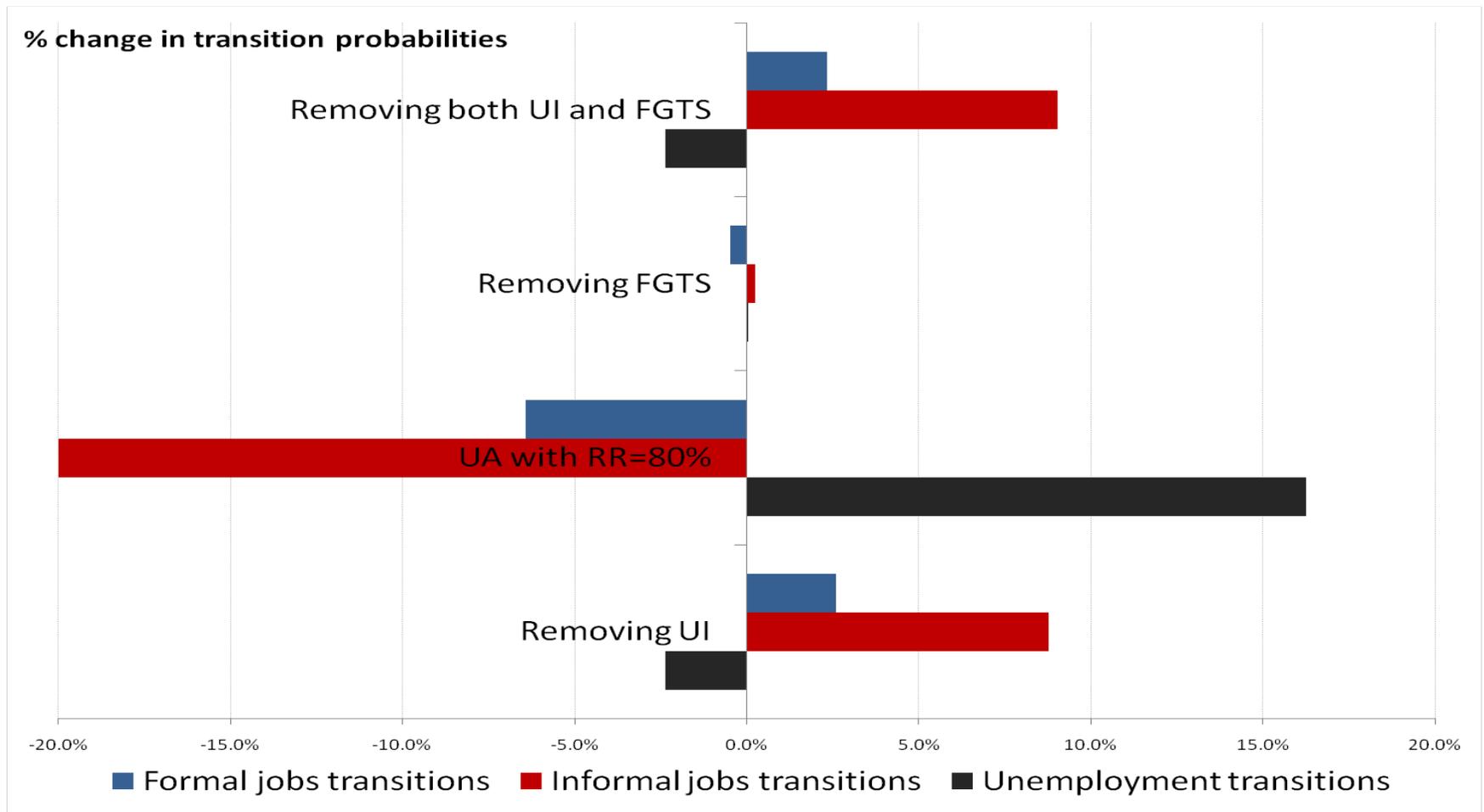
- Social security institutions managing pensions and sometimes health insurance are already having problems:
 - Undeveloped information and administrative systems
 - Problems collecting contributions
 - Low quality services (e.g., delays in payments)
- Institutions would not be able to manage another program
- Or the quality of services would further deteriorate

What do we know about labor market effects of traditional UI?

On the supply side

- Most evidence comes from OECD countries:
 - The higher the level and duration of benefits the higher the unemployment rate (*Holmlund, 1998; Vodopivec et al, 2005; and Olinto et al., 2007*).
 - But there is also evidence that UI can lead to better matches (*Tatsiramos, 2009 en DK, FR, DE, GR, IE, IT, ES, UK*)
- The evidence from MICs is less clear cut:
 - No impact on unemployment, no evidence of better matches, if anything it facilitates transitions into self-employment (*Cunningham, 2000 in Brazil*)
 - Beneficiaries have higher exit rates (*Margolis, 2008 in Brazil*)
 - But shortening the duration can reduce the duration of the unemployment spell (*van Ours and Vodopivec, 2008*)

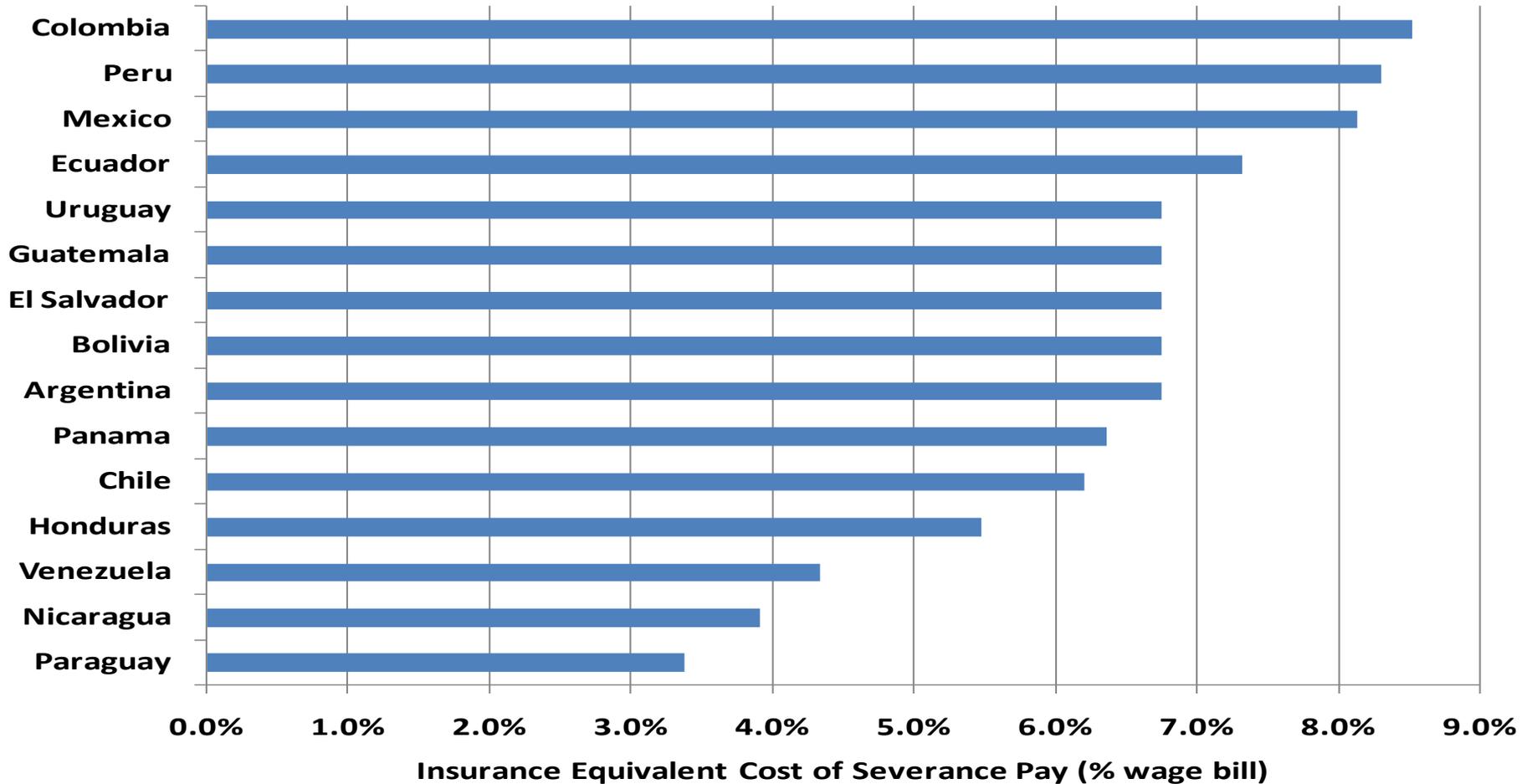
Structural models for Brazil predicts lower transitions into informal job



On the demand side

- The unemployment insurance systems can add a couple of percentage points to the tax-wedge
- There is evidence that an increase in the tax-wedge reduces formal employment
- But formal employers already face the cost of severance pay, which is non-negligible.
- If unemployment insurance replaces or reduces severance pay this effect can be neutral

Severance pay is expensive



A possible design

What are the choices?

Mandate



Replacement rate
Duration of benefits

Instruments



Risk pooling (classic model, majority of countries)
Savings (mainly in Latin America)
Redistribution

Financing



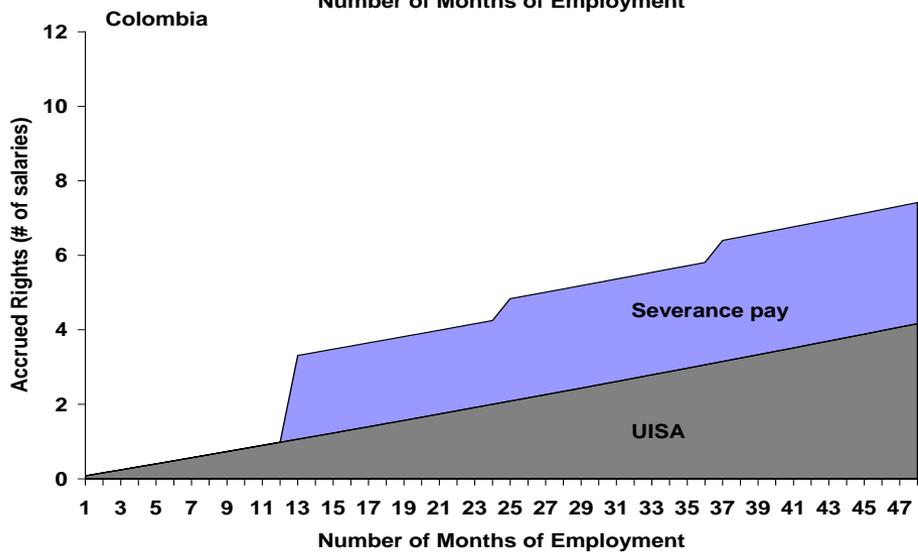
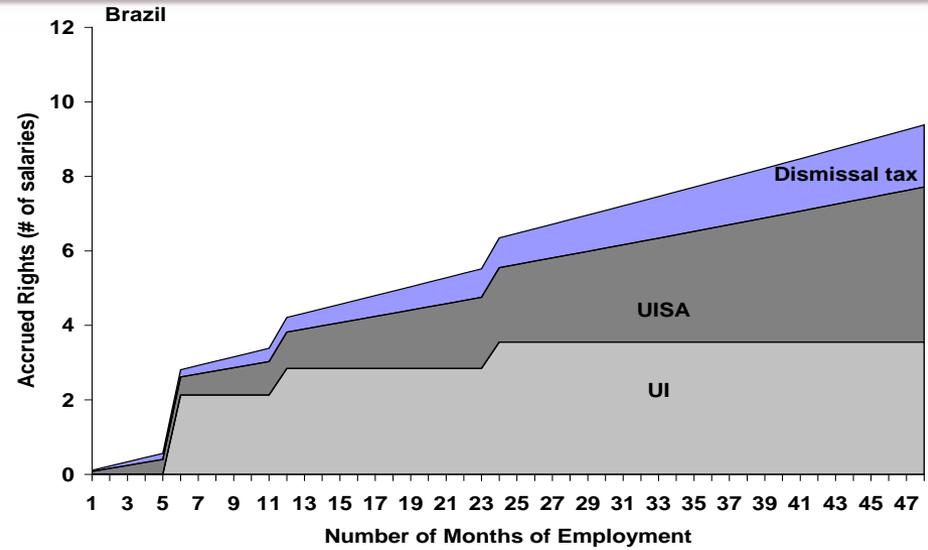
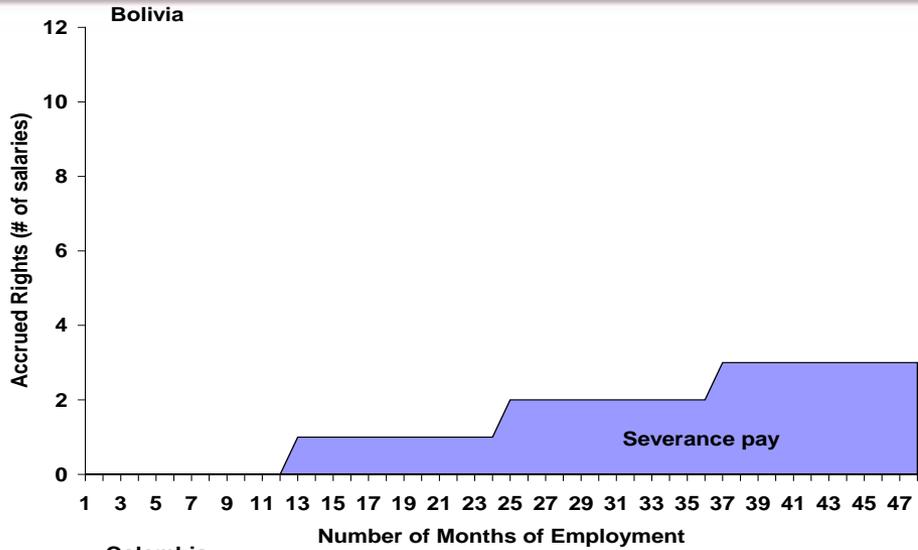
Pay-roll tax
Individual contributions
General revenues

Institutional arrangements



Which conditionalities
How to enforce them

There are no specific rules regarding the mandate but there are fiscal implications



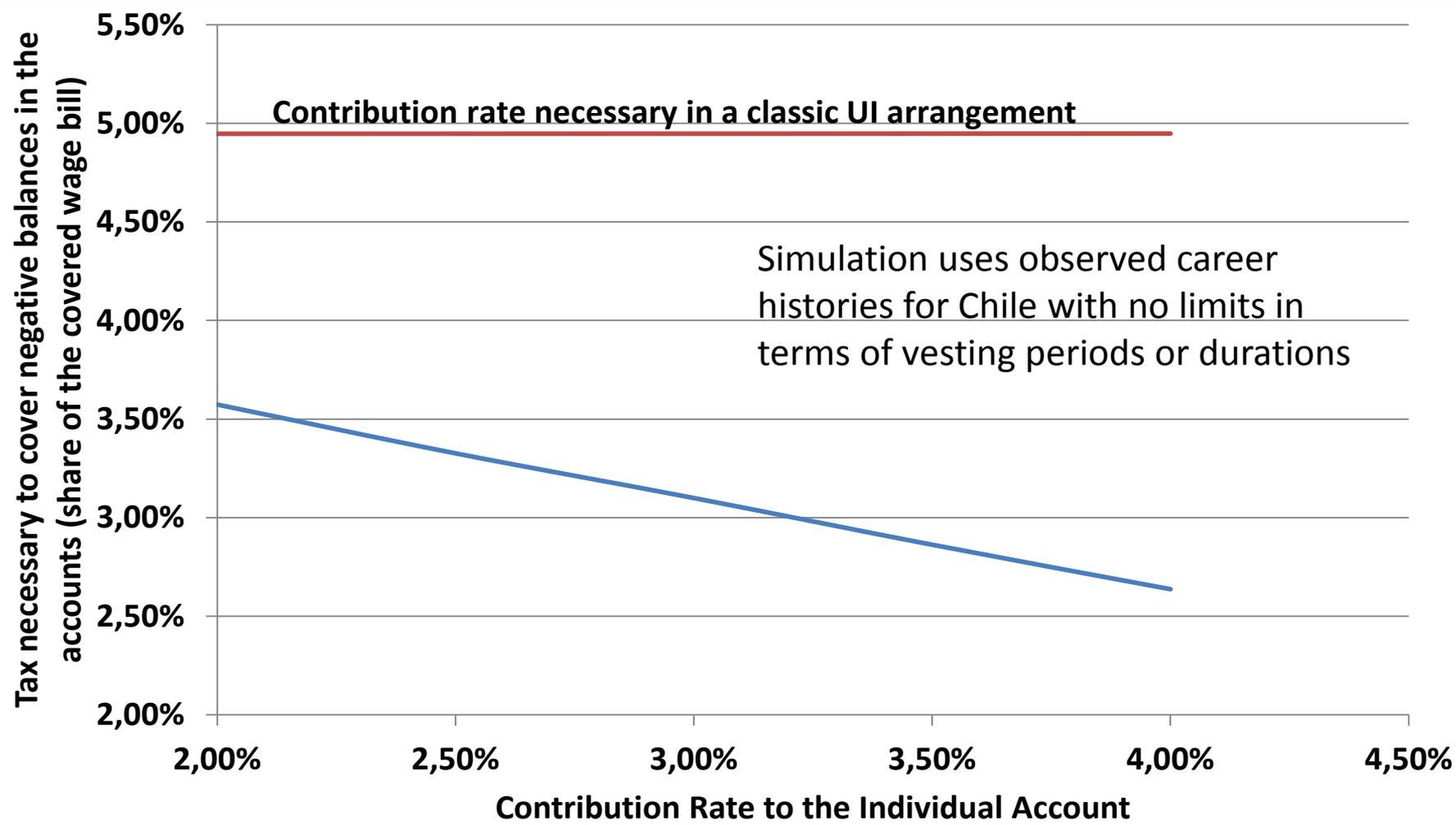
Key choice is between risk-pooling, savings, and redistributive arrangements

- In traditional risk-pooling-based UB redistribution is implicit:
 - Individuals do not contribute on the basis of their unemployment risks and costs (risk pooling is not actuarially fair)
 - Individuals who remain unemployed for longer receive implicit subsidies from others.
 - These are the subsidies that distort incentives
- An alternative is to make redistribution explicit and better targeted by relying on savings mechanisms :
 - Ask workers (and employers) to contribute to individual accounts
 - When unemployed pay benefits out of the account
 - If funds run out, subsidize and finance subsidies from general revenues not payroll taxes.
 - Any balance in the account at retirement goes to the pension

...

- There are different variants:
 - Subsidize only for certain population groups and pay out of a solidarity fund (Chile)
 - Allow accounts to go into red; individuals can borrow up to a limit and repay:
 - When working (Jordan)
 - And at retirement
 - There can also be write-downs financed out of general revenues.
 - *Notice* that a system with no limits in the borrowing and where negative balances at the time of retirement are paid out of accounts with positive balances is equivalent to UI.
 - The accounts can be funded or pay-as-you-go

Taxes and contribution rates in the case of Chile (50% replacement rate)



Based on Fajnzylber and Robalino (forthcoming)

In terms of institutional arrangements

- New UB system would need to piggyback on existing pension system:
 - Pension systems, independently of design, need to have individual accounts.
 - Need to invest in proper administrative systems (record keeping, collection of contribution, payment of benefits)
 - Administrative reforms have been successful even in low income settings (e.g., Bolivia)
- There is no point in trying to control employment status:
 - Rely on other conditionalities such as participation in training and job-search activities (*when allocating subsidies or credit*)
 - Rely on decentralized employment offices to enforce conditionalities.

Conclusions

- Supply side concerns can potentially be addressed by relying on savings arrangements with explicit redistribution
- Demand side concerns (tax-wedge) can be handled by reforming severance pay and financing redistribution through general revenues.
- Administrative concerns remain valid but need to be addressed anyways in the case of pension systems