7/2016

PEGNet Policy Brief

December 2016

Social protection: A key instrument for social, economic and political development

By Markus Loewe

Key Points

- Social protection schemes help households manage risk and poverty, but they also encourage them to take new risks related to investment. Thereby, they promote pro-poor economic growth and stabilise society and polity.
- Only a minority of the world population has access to reliable social protection instruments. Most people rely on mutual support networks and informal protection mechanisms.
- Tax-financed social protection schemes tend to be better able to reach out to poor and informal sector households.
- Universal transfers are better able to contribute to economic and political development than targeted transfers.

Poverty Reduction, Equity and Growth Network (PEGNet)
Kiellinie 66
D-24105 Kiel,
Germany
pegnet(at)ifw-kiel.de
www.pegnet.ifw-kiel.de

Social protection can be defined as "policies and actions which enhance the capacity of poor and vulnerable people to escape from poverty and enable them to better manage risks and shocks" (OECD/DAC 2009, 10). The term would thus include social insurance, social transfers and minimum labour standards, but for many experts also micro-insurance, commercial insurance and savings plans, traditional solidarity networks and group-based risk prevention instruments.

Social protection plays a key role for social, economic and political development…

For long, social protection has been neglected by the mainstream international development debate. Emphasis was put on economic growth, while social protection was seen as a gadget that countries can afford once they have become rich.

During the last fifteen years, however, a fundamental change in thinking has taken place: Today, it is widely acknowledged that social protection has a key role to play not only for the social but also the economic and political development of countries. And the process that led to the Sustainable Development Goals (SDGs) has further accelerated this trend. In the end, social protection has not been established as a separate goal in the Agenda 2030 even though many experts and activists in developing countries have asked for it. But it is highlighted as a key tool for the achievement of several of the SDGs.

SDG1 (ending poverty) in particular will not be achieved without substantial increases in social protection spending. The share of people in moderate poverty has fallen substantially during the last two decades – but the share of people in very extreme poverty (on less than 0.5 US$ per person and day in PPPs) has not decreased at the same pace. And many studies confirm that current patterns of growth and redistribution are unable to reduce global poverty rates to zero by 2030 (e.g. World Bank 2016).

The same applies, of course, to several other of the social SDGS. Many low-income people cannot afford to send their children to school (SDG4), go to the doctor when they are ill (SDG3) or buy proper food (SDG2) and improved drinking water (SDG6). And a comparison of high-income countries shows that it is very difficult to reduce income-inequality without substantial redistribution through taxes and social transfers (Joumard / Pisu / Bloch 2012).

But recent publications also confirm that social protection can be very important for economic development and employment because it constitutes an insurance against investment and business failure and hence encourages people to become economically active (e.g. Alderman / Yemtsov 2012). In the absence of social protection, especially low-income people are reluctant to invest. If ever they can make savings, they hoard them or store it on a basic savings account where these reserves are relatively safe and easy to be redrawn whenever a shock occurs, i.e. when the household experiences an unexpected expenditure (e.g. for a surgery) or loss of income (e.g. because of bad harvest). But when the same people enjoy at least some basic social protection against their most serious risks (bad health, old-age, the death of the main bread-winner of a family etc.), they start investing at least some of their savings in productive or human capital: For example, they buy machines that allow for higher future profits in any 'normal' case but also bear some risk of misinvestment. Gehrke (2014), for example, has shown that the introduction of the National Rural Employment Guarantee Scheme (NREGS) in India has significantly altered the crop portfolio of Indian farmers. Their main product is rice, which is traded at a low but guaranteed price in India. But when NREGS was established, many farmers changed to cotton and other seeds on parts of their lands. They rely on their right to ask for 100 days of paid employment by NREGS – for example in case of a bad harvest.

This means that it is wrong to argue that developing countries should grow first and invest into social protection only afterwards. Instead, we have to acknowledge that reliable social protection floors encourage poor people to invest into additional or more efficient economic activities and thereby constitute an effective trigger for pro-poor economic growth, i.e. economic growth that takes place foremost among low-income and informal sector workers. SDG8 (growth and employment) will thus be difficult to achieve without increased efforts to establish of reliable social protection mechanisms for all people world-wide.

And finally, social protection is also a key instrument for the stabilisation of states and societies. Empirical studies show that people feel better integrated into society when they are covered by fair and efficient social protection schemes. Devereux and Sabates-Wheeler (2004), for example, argue that equitable social protection schemes foster social inclusion and cohesion and raise the acceptability of state authority. Even in countries where the state has failed (e.g. Yemen, Mali or Haiti), we can imagine that the building-up of new social protection schemes may be seen as a sign of the state offering a new social contract to citizens and thereby encourage them to respect the political order and refrain from violence. In this way, social protection schemes can become a key ingredient for the achievement of SDG 16 (inclusive societies and institutions).

... but only a minority of mankind has access to reliable social protection instruments

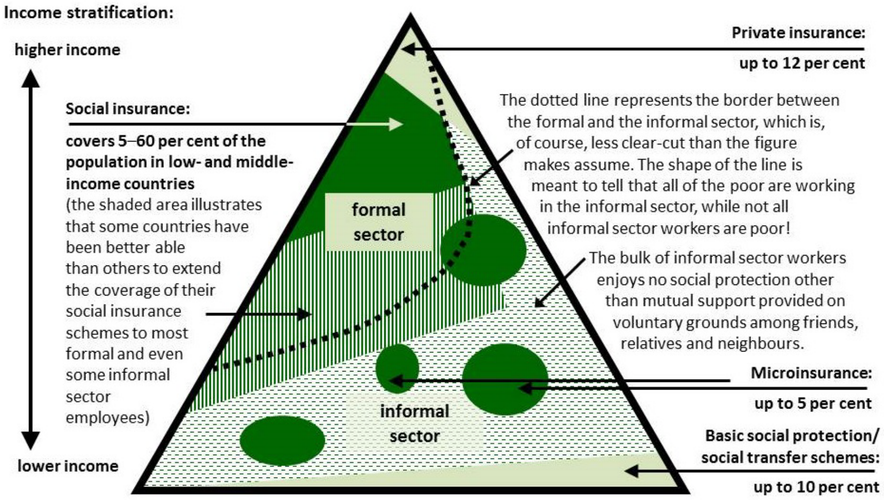
At the same time, however, the majority of people world-wide lack access to reliable social protection schemes (see Figure 1). Typically, just 10-20 per cent of people in low-income countries are covered by contributory or non-contributory public pension and health schemes (up to 50% in middle-income countries). Up to 5% of the population (the very rich) can afford to buy private health and life insurance. And some poor households are granted tax-financed social transfers. But all other households depend on traditional and informal social protection arrangements, which are limited in scope and scale and rather unreliable because they are not based on law or written contract. The majority of people is thus vulnerable to risks such as illness, unemployment, harvest failure or river flood, which means that they would fall into poverty when these risks occur. But even worse, they would face difficulties to escape from themselves from poverty again because they would have to sell land, machines and valuables, take children out of school, miss important medical treatments – and thereby reduce their future income generation possibilities. Even worse, as argued earlier, these people would shy away from making new investments when they have some savings and are ultimately kept in a poverty trap.

Contributory social protection schemes have difficulties in reaching out to the poor...

What can be done to make a change? For long, policy makers in Africa and Latin America have placed their hopes in contributory schemes that were copies of European models. The schemes provide social insurance against predefined risks such as bad health, old-age, unemployment or work-disability. Their obvious advantage is not to strain tight government budgets. But they also have several weaknesses (Table 1); for instance, they tend to be based on formal employment relations between employees and employers sharing the financial burden of the contributions. Informal sector workers, however, who account for up to 90% of the labour force in low-income countries, are either self-employed or employees without formal working contract. They would have to pay both shares of the contributions if they were meant to be covered as well. And such a financial double-burden would clearly exceed the financial capacities of most of them. In many countries, policy makers defend their reliance on contributory social insurance by arguing that sooner or later all workers are going to be integrated into the formal sector. But with the exception of a few countries (e.g. South Korea, Taiwan, Costa Rica, Israel) the developing world still waits for this process to come. In many countries, the informal sector has even grown over the last decades.

Some development experts believe that micro-insurance is the solution, which is voluntary insurance with contribution rates that are affordable for low-income earners. However, if contribution rates are meant to be

Figure 1: Most people in developing countries are not covered by social protection schemes



Source: Loewe (2010)

low, benefits have to be limited as well. And the majority of low-income people is either not able or not willing to make the contributions that micro-insurance schemes typically charge. Hardly any existing scheme covers more than a tenth of the households in its area of out-reach (schemes in Peru being the main exception). In addition, micro-insurance schemes cannot cover all kinds of risks. They find it difficult, for example, to provide full protection against health risks because the medical treatment of low-income people is almost as expensive as the treatment of higher income people. Micro-insurance can therefore not be sold at a price that is lower than the price of conventional health insurance sold to high-income people unless it is subsidised or covering only a slimmed down package. Cross-subsidisation, in contrast, is not an option because – unlike for social health insurance – membership cannot be made mandatory so that richer subscribers would quit the scheme once they realise that they pay part of the coverage of poorer subscribers (Loewe 2010).

Anyhow, tax-financed social protection schemes have two important advantages over contributory schemes (Bender / Loewe / Schüring 2015). First, they can cover all parts of the population – not only those who can afford to make at least small contributions. Second, they can support all households that are in need or belong to a specific target group and thereby provide comprehensive protection against all risks and other poverty factors – while the benefits of contributory schemes are contingent on predefined risks. Of course, tax-financed schemes can be seen as an additional burden for the government budget, but a social insurance contribution is also nothing else than a payroll tax. Social insurance members may be more motivated to pay a payroll tax that finances their own social protection rather than any other tax that finances very different kinds of government activities. But employers who bear part of the financial burden of social insurance contributions argue that they raise the costs of labour and hence constitute a disincentive to hire additional workers.

Tax-financed social protection schemes are not necessarily more expensive than social insurance systems and their funding can be drawn from very different kinds of taxes, and, hence, if wanted, contribute more thoroughly to income redistribution.

… and targeting can lower the effectiveness of social protection schemes

Another choice that policy makers have to make is whether the benefits of tax-financed social protection schemes should be targeted (needs-based) or universal (flat). Needs-based transfer schemes tend to be cheaper than universal transfer schemes if the target group (e.g. the poor) makes up just a minority of the population: Only this minority is entitled to needs-based transfer payments while universal benefits are paid to everybody (or at least all people at a specific age or in a specific situation). On the other hand, it is difficult to check which households belong to this minority. This so-called 'targeting' involves substantial errors of exclusion (poor people do not get transfers) as well as errors of inclusion (more affluent people do receive transfers). And any effort to reduce these errors raises the costs of the targeting procedure. As a result, universal benefit schemes can even be cheaper than needs-based transfer schemes if the target group makes up a majority of the population (such as e.g. the poor in low-income countries): in this case, it can be cheaper to pay out benefits to everybody than to identify the minority of non-target group households. And in such a situation, universal benefit schemes can also be superior from a political economy perspective: In particular, the small middle class may tolerate them but not needs-based transfer schemes because it does benefit from universal transfers as well but rarely from needs-based transfers.

Often, policy makers still have a preference for either contributory social insurance or needs-based (targeted) social transfers. They are reluctant to spend considerable shares of government budgets on social protection. Thereby, they overlook that the extent of economic or political effects produced by social

Table 1: Comparative weaknesses of different kinds of social protections schemes

Contributory		Non-contributory (tax-financed)	
Social insurance	Micro-insurance	Targeted transfers	Universal transfers
▪ benefits contingent on membership and the occurrence of predefined risks ▪ inadequate for very poor households		▪ financial burden for public budget	
▪ inadequate for the informal sector ▪ out-reach limited (< 5 - 60%) ▪ raises the costs of labour and thereby under-employment ▪ typically no economic / political effects	▪ membership not mandatory ▪ no redistribution ▪ out-reach typically low (<5%) ▪ difficult to cover risks without correlation to income/ wealth ▪ no political effects	▪ high error of exclusion ▪ high targeting costs ▪ low acceptability for middle class ▪ typically no economic / political effects	▪ high error of inclusion ▪ comparatively expensive

Source: Author

protection schemes depends to a large degree on the design of these schemes. It is unrealistic, for example, to expect large numbers of households to invest their savings if they are covered only by a social protection scheme that is unreliable or insuring only against some less relevant risks. Social protection schemes cannot unfold their full economic impact unless they are fully trustworthy (in the best case based on constitutional or at least legal provisions) and covering all major risks (i.e. at least bad health, old-age and the death of the main bread-winner of a household). This applies only to very comprehensive social insurance schemes covering at least a large majority of the population and for well institutionalised transfer schemes with at least not overly rigid targeting mechanisms.

And the conditions for ample effects on social cohesion and political stability are even more restrictive. Citizens feel to be taken seriously by the state if they are entitled to entirely unconditional support. Granting universal transfers to everybody is the best way for governments to make all households feel being part of a community that cares and thereby to stimulate their loyalty. All in all, universal benefits seem the best choice for having large effects not only on poverty and inequality but also on investment and growth as well as on social cohesion and political stability.

Schemes of this kind already exist in many low and middle income countries. There are, for example, universal flat social pension schemes in Bolivia, Botswana, Kiribati and Timor-Leste, while many other countries – including Nepal, Swaziland and the Bahamas have at least universal minimum pension schemes (where benefits are meant to fill only the gap between any residual income and the target minimum pension level). Namibia and the Republic of South Africa have also universal child allowance schemes. And several countries – among them Algeria, Bhutan, Cuba and Botswana – have universal public health systems. None of these schemes is excessively expensive in relative terms. And a UNICEF-sponsored pilot scheme granting flat transfers to all inhabitants of eight randomly selected villages in Madya Pradesh, India, has shown that even a universal citizen grant could be financed and would have tremendous social, economic and political effects (Davala et al. 2015).

Author

German Development Institute:
Markus Loewe
Markus.Loewe(at)DIE-GDI.DE

References

Alderman, H., and R., Yemtsov (2012). Productive role of safety nets, Social Protection and Labor Discussion Paper 1203, World Bank

Bender, K., Loewe, M., and E., Schüring (2015). One size fits all? Die Rolle der Sozialversicherung in Entwicklungsländern, in: Laurenz et al.(eds.), Handbuch Sozialversicherungswissenschaft, Heidelberg: Springer, 1077-1096

Davala, S., Jhabvala, R., Mehta, S.K., and G., Standing. et al. (2015). Basic income: A transformative policy for India, London: Bloomsbury Academic

Devereux, S., and R. Sabates-Wheeler (2004). Transformative social protection, Brighton: IDS (Working Paper 232)

Gehrke, E. (2014). An employment guarantee as risk insurance? Assessing the effects of the NREGS on agricultural production decisions, BGPE Discussion Paper 152

Joumard, I., Mauro, P., and D., Bloch (2012). Tackling income inequality: The role of taxes and transfers, OECD Journal of Economic Studies.

Loewe, M. (2010). New approaches to social protection: Microinsurance, DIE Briefing Paper 8/2010

OECD/DAC (2009). The role of employment and social protection, Making economic growth more pro-poor in Promoting pro-poor growth: Social protection. Paris, 11-15

World Bank (2016). Taking on inequality: Poverty and shared prosperity 2016, Washington, D.C.

PEGNet Policy Briefs