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The Reform of Unemployment Compensation: Choices for East and West

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THE REFORM OF UNEMPLOYMENT COMPENSATION: CHOICES FOR EAST AND WEST

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Abstract

The rapid emergence of open unemployment is accompanying moves towards market economies in Eastern European countries. Governments are responding with unemployment benefit schemes which may be seen as a natural and positive complement to economic reform. At the same time, compensation for the unemployed is often viewed in a negative light in Western Europe with the 1980s having been a period of retrenchment in the face of higher levels of unemployment. This contrast is used in the paper to stimulate re-consideration of principles of income support for the unemployed. Given that any civilised society would wish to provide for the unemployed, what form should compensation for unemployment take? The paper considers the choice between contributory unemployment insurance and means-tested unemployment assistance, stressing the positive aspects for labour markets of the former. The coverage of OECD unemployment compensation schemes is discussed and new unemployment benefit schemes in several Eastern European countries are briefly described. The paper concludes with suggestions for reform, and for assessment of reform, in East and West.

* This paper was written for the session on "European social security: issues and prospects" at the European Economic Association Annual Congress, Lisbon, 31 August-2 September 1990. (It will be published in the European Economic Review Congress Proceedings.) The paper draws heavily on joint work with A.B. Atkinson, of the London School of Economics, on unemployment compensation and labour market transitions in the OECD area, and with Sheila Marnie, of the European University Institute, on emerging unemployment benefit schemes in Eastern Europe. I thank both of them, and Maurice Marchand (CORE), for comments. I am indebted to Nicholas Barr (LSE) and Zsuzsa Ferge (Eotvos Lorand University, Budapest) for information. None of the above are responsible for the views in this paper and any errors are my own.

1. INTRODUCTION

Discussion of unemployment compensation by economists in the West is typically concerned with its negative aspects. By how much do unemployment benefits raise wages, encourage quits or layoffs, or excessively prolong spells of unemployment? On this view, unemployment compensation needs pruning and this happened in many OECD countries during the 1980s (OECD, 1988).¹

The current situation in Eastern Europe presents a marked contrast. The emergence of open unemployment, accompanying moves towards market economies, has resulted in a different attitude towards unemployment benefit and in the introduction of new schemes. Unemployment compensation may be seen as a natural complement to the reforms taking place. An economic system entailing (in principle) the right to work is being replaced by one in which there is a risk of unemployment. Payment of benefits during unemployment is necessary to help people accept that risk and to allow economic change to take place. The same is true in China where the introduction of unemployment insurance in 1986 was part of a package of policies designed to introduce flexibility into the urban labour market (Atkinson, 1990a). On reflection, this view of unemployment compensation should come as no surprise to Western observers. Unemployment compensation can play a positive economic role in theoretical models of the labour market, this applying particularly to unemployment insurance (see below). This has at times been reflected in policy in the OECD area; an example is the introduction of an earnings-related supplement to unemployment insurance in Britain in 1966, this being justified at the time as much on economic as on social grounds (Micklewright, 1989).

The contrast between the current situation in East and West provides the stimulus for this paper. Given that any civilised society would wish to provide for the unemployed, what form should financial support take? Do the schemes emerging in Eastern Europe make sense? What lessons can be learnt from the experience of unemployment compensation in Western countries? Can the West learn from initiatives in the East where change is comparatively unimpeded by the precedent of history? In a short paper it is possible only to air some relevant issues rather than to answer these questions. Section 2 considers the important distinction between contributory

¹ The changes to unemployment compensation during the 1980s in the UK are detailed in Atkinson and Micklewright (1989).

unemployment insurance (UI) and means-tested unemployment assistance (UA), a distinction relevant for both income support and the operation of the labour market. This subject has seen too little light in recent years, despite a shift away from UI in several OECD countries (OECD, 1988, p125). One choice for the West is whether to retain UI as the principal form of unemployment compensation; section 2 provides some positive arguments. Section 3 outlines the main features of emerging schemes in Eastern Europe. Section 4 considers reform, and the assessment of reform, in both East and West.

2. INSURANCE VERSUS ASSISTANCE

Setting aside radical alternatives such as a basic income guarantee, the two principal ways of providing income support during unemployment are unemployment insurance (UI) and unemployment assistance (UA).² UI is contributory (contributions coming from employers and/or workers), qualification depends on an individual's employment history, benefit is usually set as a proportion of past earnings, is of limited duration, and is not in general reduced if the claimant or his family have other sources of income. UA does not typically depend on the employment history, and is of unlimited duration, but is subject to a test of family income and is not related to past earnings. Both benefits may be withheld from those who quit work voluntarily, who fail to search for work, or who turn down job offers.

All but three OECD countries have UI and many have in addition some form of UA for those who do not qualify for insurance benefit or who exhaust their entitlement.³ However, the details of both types of scheme vary considerably from country to country (OECD, 1988). In the United States there is no real means-tested safety-net and the unemployed without UI may receive nothing. Most European countries do have UA schemes, although there are notable exceptions where eligibility is far from universal, e.g. Italy and Spain.

Western analysts of unemployment often treat UI and UA as having the same impact on the labour market, ignoring both the different level of income support the

² Atkinson (1990b) discusses the possibility of a basic income scheme for both East and West.

³ My use of the term UA includes general means-tested programmes aimed at not only the unemployed.

schemes may provide and the different conditions under which payments are made (Atkinson and Micklewright, 1990). UI ranks above UA in terms of social policy in that it provides benefit without the need to undergo a means-test, and is relatively free of problems of non take-up. At first sight, this might imply that UA is to be preferred on economic grounds, the reduction of benefit via means-testing increasing the incentive to work. If a labour market is characterised by frequent occurrence of second jobs, as in Hungary, then, on this view, means-testing of unemployment compensation increases the incentive to find another main job. Means-testing, some would argue, will increase outflows from unemployment and lower inflows. Moreover, a means-tested benefit may seem tempting on grounds of cost; benefit, it might be argued, being targeted on those with the greatest need.

This view of the differences between UI and UA is too limited and there are a number of reasons why UI may be preferred to UA. First, a state-organised UI scheme represents an important demonstration of "solidarity" among a workforce facing labour market upheaval. In Western labour markets, this has been an important consideration in the past (Atkinson and Hills, 1989). In Eastern Europe, any policy that might foster social solidarity in the face of change would seem to have much to recommend it. Contributory benefit implies redistribution from those in safe jobs to those becoming unemployed and the existence of a contribution record, or a period in covered employment, implies benefit that is "definite and claimable as of moral if not legal right" (Board of Trade, 1909). The notion of benefit "as of right" (subject to certain conditions) may replace that of a guaranteed job.

Secondly, benefit "as of right" for those with an employment record provides an incentive to enter the labour force. This is the "entitlement effect" of UI mentioned by Friedman in his Nobel lecture (Friedman, 1977). The argument can be adapted when the labour market is segmented (Atkinson, 1990c). Assume two segments, a primary and a secondary sector, and let UI be introduced with coverage restricted to the primary sector; this could be because the primary sector is defined as representing the formal economy and the secondary sector as the informal economy. The prospect of UI in the event of future unemployment improves the total reward offered by the primary sector, providing an incentive to take primary sector jobs; wages may also be reduced in the primary sector. In this respect, the introduction of a proper UI scheme in Italy, for example, could be seen as a way of influencing choice between the legal and the underground economies.

Thirdly, UI does not involve high implicit marginal rates of tax on the earnings of the family of an unemployed person. The same is not true of UA where the family means-test implies that the benefit will typically be reduced if other income is present. The implicit marginal rate of tax may be 100% for earnings above some disregarded level, implying a strong disincentive to work. This represents a neglected aspect of the difference between UI and UA. When considering the implications of means-testing for family labour supply in Eastern European labour markets, the high incidence of two-earner couples should be noted; participation rates for women of working age are typically in the range 75-85%. Any reform of social security in Eastern Europe which threatened these levels of participation should not be seen as a positive step. The distinction between UI and UA is therefore an important one. When seeing how schemes in OECD countries actually work in practice it is correspondingly important to distinguish between the receipt of the two types of benefit; it is not sufficient to describe coverage of unemployment compensation as the proportion of the unemployed receiving either benefit (e.g. Burda, 1988, Table A2). Tables 1 and 2 show the proportions of the registered unemployed stock in Britain and West Germany receiving UI and UA in 1988. One feature stands out: the proportions receiving UI are low. Nor are these sorts of figures unique to the countries concerned; the proportion of the unemployed stock receiving UI in the USA, for example, has been estimated to be less than 30% in 1987 (Blank and Card, 1989).⁴

One reason for the low coverage by UI of the unemployed stock in European countries is long-term unemployment. As is widely known, the British UI system does not pay benefit to those unemployed for over a year and UI in West Germany is also of limited duration. On the other hand, the importance of other reasons for the non-receipt of UI is not so well known. In Britain, these result in less than half of men in the stock with incomplete spells of less than a year being in receipt of UI - see Table 2. The table shows that an insufficient employment record is an important reason for the lack of UI but we should also note the significance of administrative delays and of "premature" exhaustion of entitlement, resulting from previous spells of unemployment.⁵

⁴ The Blank and Card figure refers to unemployment defined on a search criterion.

⁵ A detailed analysis is given in Micklewright (1990).

Table 1: Proportions of the Registered Unemployed Stock
in Receipt of UI and UA, 1988

	% Britain	% West Germany
Unemployment Insurance (UI)	26	40
Unemployment Assistance (UA)	56	23
neither UI nor UA	<u>18</u>	<u>37</u>
	100	100

Source: (i) Britain: unpublished data described in Micklewright (1990), data refer to November and the proportion receiving UI includes those receiving UA supplementation (the proportion with UA refers to the receipt of UA alone) (ii) Germany: Brunhes and Annandale-Massa (1989), data refer to December (the definition of UA does not include Sozialhilfe).

Table 2: Proportion of the Male Unemployed Stock Registered
for less than a year in receipt of UI (with or without UA)
and reasons for non-receipt for those not receiving,
Britain 1988

	%
Receiving Unemployment Insurance	41
No Unemployment Insurance	<u>59</u>
	100
Reasons for non-receipt:	
Insufficient Contributions	37
Waiting to be assessed	23
Exhaustion of Entitlement	32
Other Reason	<u>8</u>
	100

Source: see Table 1 (average of May and November data).

The figures in Tables 1 and 2 are a reminder that UI does not work "on the ground" in the way that a social security manual might suggest. This is a lesson that needs to be learned in both West and East. UI alone has not, in the West, provided adequate coverage of the unemployed:

"unemployment compensation schemes have been characterised by decreasing effectiveness in that they have not reached high-risk groups such as first-time job seekers, those re-entering the labour force, the long-term unemployed and workers who have had multiple spells of unemployment" (OECD, 1984, p79).

OECD income support schemes were not designed to cope with the levels of unemployment experienced in the 1980s; they should not necessarily be seen as models appropriate to dramatic labour market upheaval in Eastern Europe. It is on grounds of inadequate cover that some schemes in the West cannot be recommended to the East. This argument is very different from one which maintains that it is the disincentive effects of Western European schemes which should not be risked in the East (e.g. Layard, 1990). The evidence on the effect of unemployment compensation on labour market transitions in the OECD area does not, in my view, support this latter argument (this evidence is reviewed in Atkinson and Micklewright, 1990).

3. UNEMPLOYMENT COMPENSATION IN EASTERN EUROPE

Unemployment compensation schemes have not existed in Eastern Europe for most of the post-WWII period. The reason has been the right of the individual to work in planned economies (and the obligation to do so); unemployment has not officially occurred. Moreover, the incentive structure for enterprise managers has resulted in labour hoarding and Eastern European economies have been characterised by chronic labour shortages. This is not to say that Eastern European labour markets have been static; voluntary quitting has resulted in considerable labour turnover - figures of 15-20% a year have not been uncommon. Partly as a result, unemployment has not in fact been absent (e.g. Gregory and Collier, 1988) and its existence attracted increasing official recognition in various countries in the 1980s. The skeleton of labour market institutions familiar in the OECD area, e.g. employment offices, has been developed in several countries, although this is now clearly in need of fleshing out.⁶

The impetus for the development of unemployment compensation in Eastern Europe is of course the emergence of open unemployment. In Poland, where dramatic structural adjustment has been adopted as the solution to the economy's ills, the stock of unemployment benefit recipients was over 550,000 by June 1990, about 4% of the workforce, compared to only 6,000 the previous December. Forecasts put the unemployment rate by the end of 1990 at 10-15%. Change in Hungary is being effected in a less dramatic way. Unemployment was only about 1% in Spring 1990 but

⁶ When measured in terms of percentage of GDP, the projected Hungarian active labour market budget for 1990 (described in Matoricz, 1990) seems to be within the OECD range (given in OECD, 1988).

fear of what may come is apparent.⁷ The USSR is hesitating over major reform but it is widely recognised that this must entail substantial re-allocation of labour and open unemployment (Marnie, 1990).

A brief description follows of unemployment compensation in East Germany, Poland, Hungary and the USSR, these countries covering the range of political and economic reforms taking place in Eastern Europe. For reasons of space, I am unable to cover many important aspects, in particular the relationship between unemployment compensation and other policies affecting the labour market.⁸

i) East Germany

A temporary scheme was set-up in February 1990 but union with West Germany brings in the latter's unemployment compensation system. The questions which need to be asked are about the ability of the German system to cope with a level of unemployment in the Eastern part of the country that looks set to be well in excess of that previously experienced in the Western part.⁹ We have seen that UI recipients are in a minority in the West German unemployed stock.

ii) Poland

As part of the structural adjustment programme begun in January 1990, Poland introduced an unemployment benefit system paying 70% of the previous wage for three months, reducing to 50% for another six months and then dropping to 40% thereafter without limit on duration. The benefit is subject to a maximum equal to the average wage and a minimum, which is indexed monthly, equal to 35% of this. Labour force entrants with no previous wage receive the minimum benefit or one and half times this depending on educational level and duration of unemployment. The benefit is jointly financed by employer contributions and central government.

⁷ Janos (1990) cites survey evidence in which 30% of unskilled workers reported that they were very worried about their job prospects.

⁸ The details I give are those available in Summer 1990; they may quickly become out-of-date.

⁹ The West German Finance Minister was reported in Summer 1990 as having said that his aim was to limit unemployment to 10% in unified Germany (Guardian Weekly, 1 July 1990). Given the West German rate at the time, this would imply a rate of some 20% in East Germany.

iii) **Hungary**

True unemployment compensation was introduced in January 1989 paying a maximum of 12 months of benefit to those employed for at least 18 months during the previous three years. The initial rate is 70% of the previous wage, falling to 60% after 6 months (lower rates for voluntary quitters). Benefit is subject to a strict administrative test, the unemployed having to prove rejection by employers to which they may be sent by an employment office. The refusal of a job offer at a wage equal to the benefit level leads to disqualification. Unlike in Poland, those without an employment record do not qualify for benefit. The benefit is currently financed by central government but there are proposals to bring it into the social insurance scheme, to which both employers and employees contribute. Those exhausting benefit (but not those who fail to qualify) can apply for a means-tested benefit financed and run by local councils.

iv) **The USSR**

No unemployment benefit as yet exists in the USSR.¹⁰ However, a draft employment law under discussion during 1990 proposes a flat-rate benefit, payable for 6 months, of 70-80 roubles a month for job losers and about 25-35 roubles for labour force entrants (Pravda, 6 April 1990). This is to be a minimum paid for by central government (although proposals for both enterprise and employee contributions have not been ruled out) which republics can supplement if they wish. These levels of benefit can be compared with an "official" poverty line of 78 roubles a month and an average wage in 1989 of 240 roubles a month.¹¹ The proposed benefits, particularly for new entrants, appear to be set at a low level.

¹⁰ Workers made redundant receive 2 months wages (3 in cases where the enterprise is liquidated or if they register at a state employment agency).

¹¹ Trud v SSSR, 1988, pp227-8, and Ekonomika i zhizn, 1990, number 6.

4. REFORM AND THE ASSESSMENT OF REFORM

Many Western analysts of labour markets may see "reform" of unemployment compensation as meaning the changing of benefit rules so as to increase incentives to work. Some may wish to see "workfare" conditions for unemployment benefit, the payment of benefit in return for unskilled work.¹² But, in my view, the evidence on the supply side impact of unemployment benefits does not indicate effects that are both large and robustly determined. Nor can evidence from the OECD area be seen as necessarily representative of effects in Eastern Europe. As far as the demand side is concerned, the evidence (largely from the US) is rather stronger on the likely impact of increased experience-rating of employer UI contributions in countries where temporary layoff unemployment is prominent. On the other hand, experience-rating would seem to have little to recommend it for the foreseeable future in nascent UI schemes in Eastern Europe, where one aim of labour market policy must be to encourage reallocation of labour.¹³

The focus on disincentives obscures the fact that reform may also mean a strengthening of unemployment compensation schemes. The aim should be the provision of adequate protection to all those satisfying reasonable (rather than punitive) availability and job search conditions.¹⁴ For the reasons described earlier, the strengthening of insurance benefit should be seen as a priority. Moreover, the positive economic arguments for UI show that an improvement of income support need not be at the expense of efficiency.

Two aspects of income support for the unemployed in Eastern Europe are particularly worthy of mention. Firstly, the benefit coverage of people who are recurrently unemployed needs to be considered. As in the OECD area, there will be many persons who move in and out of unemployment; temporary jobs are a prominent

¹² Le Grand and Okrasa (1988, p12) point to the irony of this suggestion; Eastern European countries are trying to reduce public-funded "jobs" which are uneconomic in private sector terms and which result in hidden unemployment.

¹³ In the same way, the lack of experience-rating in the Italian CIG scheme (which funds temporary lay-offs) may contribute to labour market flexibility, given the extreme difficulty in making a permanent lay-off in Italy (which is described in Emerson, 1988).

¹⁴ The rules of the benefit system in Hungary regarding the refusal of job offers (described earlier) would seem to be punitive, having the effect of "pushing" people into jobs paying wages beneath those previously earned.

feature of capitalist economies. Secondly, a proper safety-net is needed for those without UI cover.¹⁵ Eastern European countries need to get this in place from the outset; the experience of Britain in the 1920s is salutary, a succession of amending UI laws failing to come to grips with the problem of high unemployment.

Finally, reform must be assessed in both West and East. The workings of benefit systems need to be continually and publicly monitored using both administrative and household survey data sources. Some countries are obviously better than others; it would be difficult for an Eastern European country to produce less than Britain, where the amount of published information based on administrative sources is extremely small. Hungary seems well-placed with its computerised employment offices. Regular information is needed relating to both the unemployed stock and flow, registered and unregistered. The proportion of the registered stock receiving benefits and the reasons for non-payment for those not in receipt can be determined from information collected as part of the administration of unemployment compensation. The same applies to the proportion of the inflow who receive benefits at any time in their spell, and the proportion of all weeks of registered unemployment covered by benefits. Survey data are needed to measure benefit take-up and to monitor those unemployed who do not claim. Reform in the West must take place in the full knowledge of what present systems do, or do not, achieve. Unemployment compensation schemes in the East cannot be left to operate unchecked. Whatever one's view about the economic impact of unemployment compensation, there can be few supporters of "ignorant" reform.

¹⁵ This applies to several OECD countries as well. In this context, the partial extension in the US during 1990 of the eligibility to AFDC of families headed by an unemployed parent is a positive step.

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