

Europe and Central Asia Economic Update “Social Protection for Recovery”

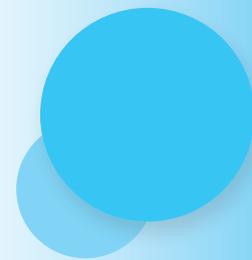
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Executive Summary

The Russian Federation’s invasion of Ukraine has triggered a massive human displacement crisis, adding to already historically high global refugee levels. Output in Europe and Central Asia (ECA) is forecast to contract by 0.2 percent in 2022, reflecting negative spillovers from the invasion. Escalating geopolitical tensions have triggered a possible energy crunch in Europe. If the war escalates, regional output could decline even further. This update summarizes recent developments and presents the economic outlook for the ECA region. It also focuses on social protection, which is a key policy instrument for protecting workers and households from adverse shocks faced by the region, and on the policy options that countries have to address the energy crisis.

It is projected that ECA’s output will barely return to growth in 2023, with gross domestic product (GDP) set to expand 0.3 percent. This outlook is predicated on slowing inflation, tightening global financing conditions, softening external demand, and easing supply chain bottlenecks. A protracted war would likely heighten policy uncertainty and fragment regional trade and investment integration.

This ECA Economic Update focuses on social protection—critical government services in this context of repeated shocks and uncertainty. Globalization, demographic trends, and technological innovations are transforming European labor markets, altering their institutional and contractual arrangements, and creating disparities and vulnerabilities in various segments of the labor force. The green transition will entail a reorientation of economies to sustainable methods of production and consumption, which will adversely affect the well-being of workers employed in “brown” industries. There is also an acknowledgment of the increasingly large role that systemic risks—economic, health, or climate-related—play in driving poverty and vulnerability. Social protection systems in ECA will need to be reformed to address these challenges and provide adequate protection to workers and families. Key policy questions in this context are whether countries should protect jobs or the incomes of workers, and whether social insurance schemes should be contributory and tied to workers’ specific employment relationships or noncontributory and unrelated to workers’ job characteristics.



Looking back at ECA countries' social protection response to the COVID-19 pandemic, the average country in the emerging and developing part of the region spent about 2.3 percent of GDP on social protection measures, compared to the average of 1.4 percent of GDP for the rest of the world. ECA countries spent, on average, 1.0 percent of GDP on job protection policies, while the average spending in other regions of the world was only 0.4 percent of GDP.

Cross-country analysis demonstrates that from the beginning of the pandemic until the end of 2021, job protection policies appeared to have contained the decrease in employment, increase in inactivity, and poverty headcount rates, but they had no clear effect on GDP recovery. These effects were significant only in countries with weaker pre-pandemic social insurance systems. In countries with broader coverage of the social insurance system, the income and job protection programs appear to have had limited impacts on employment and poverty. Moreover, firm-level analysis shows that job protection policies—and wage subsidies in particular—interrupted employment reallocation: there was relatively lower labor movement from less to more productive firms in countries with higher job protection expenditures during the pandemic.

The region's social protection systems also must grapple with shocks triggered by the war in Ukraine. Millions of Ukrainian refugees have sought protection in Europe. So far, the ECA region has been successful in providing refugees immediate food and shelter, but over the medium and long term, countries will need to accommodate them in ways that ensure the well-being of the refugees and the host communities. Migrants from Central Asia in the Russian Federation and their families back home may be affected by the economic effects of sanctions. Increases in energy and food prices are already affecting vulnerable groups throughout ECA, and social protection systems in the region have quickly begun to address these challenges by extending utility subsidy schemes in ways that can be inefficient, insufficient, and fiscally unsustainable. A more targeted approach is needed.

Beyond the shocks of the pandemic and the war in Ukraine, labor markets in the region have been undergoing changes for which employment-based social insurance schemes may not be prepared. In emerging market and developing economies in ECA, around 17 percent of the workforce is in nonpermanent and/or part-time employment, and this share exceeds 30 percent for young workers and has increased over the past two decades. As temporary and part-time employment expands, job tenure decreases. The average job tenure is declining for younger cohorts throughout the region. For example, a worker born in the 1980s in the European Union has, on average, 3.3 years shorter tenure than a worker born in the 1950s. This difference was 4.7 years in the Western Balkans and 7.7 years in Türkiye. Tenure is declining faster for women, the less educated, and the young. These transformations in the labor market risk leaving vulnerable groups unprotected. Upon job loss, individuals who were previously in nonstandard employment are less likely to receive benefits than those who were in standard employment. Similarly, employees who have repeatedly changed jobs and gone through unemployment spells can expect to have significantly lower pensions than those who have remained in full-time, permanent employment.

ECA countries will need to reform their social protection systems to address the challenges brought by the pandemic, the war, and the long-term transformations of the labor market. Combining generous income protection measures with specific job protection policies might be optimal to shield the vulnerable groups of the population from adverse shocks, promoting long-term economic recovery and sustainable growth. This blended approach could be based on publicly financed policies like a guaranteed minimum income, a negative income tax scheme, or a universal basic income—programs designed to protect people from catastrophic losses regardless of their employment status or type of job contract. At the minimum, programs should be means-tested to ensure that they reach the poorest and those who face the most significant shocks. Job losses and transitional unemployment should be insured by national programs supporting unemployment income instead of employer-provided arrangements like severance pay.

When such measures are in place, governments can adapt their social protection policies to rapidly changing labor market conditions by implementing regulatory reforms that gradually remove restrictions on firms' hiring and dismissal practices. This is especially important as countries carry out the green transition, where entire sectors or types of jobs may disappear so that employment-based schemes will not be able to protect the affected groups of the population. Employment assistance programs and other active labor market policies, such as skills training, entrepreneurial support, and intermediation, can be helpful to this end when well-designed.

The social protection systems of ECA countries are heterogeneous in their distance to this optimal design. In many countries, categorical, nontargeted social assistance benefits and contributory insurance schemes are the norm. In others, the transition to means-tested and more effective schemes is already in process. There are clear opportunities for reforms of social protection systems in ECA that will allow countries to better protect their citizens from short-term shocks and longer-term structural changes.

Reforming social protection systems may imply substantial costs. The lasting impacts of the pandemic and the economic shock of war in the region have strained countries' fiscal systems and put many countries in Europe in fiscal distress. The low tax base and high degree of informality create major challenges to raising revenues in a fiscally sustainable way for the lower-middle-income countries in ECA. In this environment, the blended approach of noncontributory (financed by the government) and contributory financing schemes could represent the most cost-effective mechanism to protect vulnerable populations and promote economic recovery. Key to the successful implementation of such systems is also the broader use of digital tools to manage the massive amounts of administrative data needed to monitor the welfare of households and individuals and to design better targeted programs.