had existed." Egypt's government sought to justify the trade union monopoly conferred by law on the Egyptian Trade Union Federation by declaring that it "represents the wish of the workers and corresponds to the needs of many countries, including developing countries." And the Seychelles government told the ILO that the legal monopoly of the National Workers Union was established "after the voluntary dissolution of all trade unions."

In the absence of free unions and collective bargaining, many governments feel obliged to reach out to formal sector workers through labor regulations and special privileges. This is particularly true when the government needs the political support of strong urban groups in order to remain in power. One result is that labor market distortions are particularly severe in many countries that repressed labor unions. Overstaffing in the public sector, high minimum wages, and restrictions on firing—policies introduced in Congo, Kenya, Sudan, Tanzania, and Zambia in the 1960s—reflected political realities for the governments that took power and repressed labor unions after independence. In Egypt in the 1950s and 1960s President Gamal Abdel Nasser, needing the support of the urban middle class, promised their children public sector jobs upon graduation from college. In Bangladesh during the 1980s General Hussain Mohammad Ershad, likewise needing the support of urban labor, negotiated with the country's federation of labor unions and agreed to increase public sector wages, severance pay, allowances, and nonwage benefits.

Not all countries that repressed unions adopted inefficient labor policies—Korea before 1987 is a notable example—and not all countries that allowed unions to operate freely had good labor outcomes. But the probability of governments passing inefficient labor legislation may be higher when workers' rights to representation is not protected. Empirical analysis finds that political liberties, which almost always go hand in hand with the freedom of unions to organize, are associated with less dualism in labor markets and a larger formal sector. Some East Asian countries both restricted union activity and achieved rapid growth in formal employment with only a moderate tendency toward dualism. But they appear to be exceptions.

Denial of workers' rights is not necessary to achieve growth of incomes. It is possible to identify the conditions and policies under which free trade unions can advance rather than impede development. Unions are likely to have positive effects on efficiency and equity, and their potential negative effects are likely to be minimized, when they operate in an environment in which product markets are competitive, collective bargaining occurs at the enterprise or the plant level, and labor laws protect the right of individual workers to join the union of their choosing, or none at all.

### CHAPTER 13

**Dealing with Income Insecurity**

Sharp drops in income from work can have a profound impact on the living standards of workers and their families. Unemployment, disability, and old age are all important causes of poverty in industrial and developing countries alike, and of deeper poverty for those already poor. Dealing with these risks is particularly important in transitional economies. Most societies have developed ways of coping with the threat to living standards from both expected and unexpected falls in income. Often this involves some combination of private saving, informal support mechanisms, and obligations on employers. Governments step in when these informal or private solutions prove insufficient. Households may find it difficult to borrow to cover temporary falls in labor income. Community support mechanisms break down when there is a community- or economy-wide shock, and they tend to decline with urbanization and the diminishing importance of the extended family. Private markets for unemployment and disability insurance and old age pensions are limited or absent, in
part because they can suffer from perverse incentive effects such as adverse selection (only those likely to need insurance buy it) and moral hazard (once insured, individuals are less likely to avoid risky behavior).

How can governments best fill the gaps that traditional and market-driven arrangements leave? This chapter examines the ways in which governments of low- and middle-income countries can help households deal with labor market risks in both the informal and the formal sector. It also identifies the pitfalls that governments face in trying to do so.

**Income security for informal sector workers**

Informal sector workers in rural and urban areas face a much greater risk of income loss than those in the modern sector. But they are also the group for whom it is most difficult to provide greater security through public intervention. Income loss is mostly associated with loss of employment, which can occur either because no jobs are available—because of seasonal or more permanent changes in labor demand—or because of incapacity to work as a result of physical disability, sickness, or old age. The vast majority of workers in low- and middle-income countries depend upon informal arrangements to provide insurance against these risks, but governments often intervene to complement them. Public works programs, when well designed, avoid crowding out private transfers, and have often been used to reduce the risks informal sector workers face.

**Community support and private transfers**

Employer-worker relations in the informal sector are governed by social customs and traditions. For wage earners the informal employment arrangement often includes an element of insurance and risk sharing, with employers agreeing to pay workers a fixed wage while they remain employed, regardless of seasonal or other fluctuations in demand. It is also common for employers to provide loans to workers who face unexpected expenses, or to support older workers or those unable to work for health reasons. This type of support is never formally agreed upon in advance. But in many countries informal commitments by employers are an important part of socially acceptable codes of conduct, especially in rural areas.

Financial help from relatives remains the principal form of income support and redistribution in developing countries. The extended family system is an important way of providing extra income and security to individual workers and their immediate households. For example, among a sample of urban poor in El Salvador, 33 percent reported receiving private transfers, which on average accounted for 39 percent of their total income (Table 13.1). In Malaysia private transfers accounted for almost half the income of the poorest fifth of households. Nearly three-quarters of rural households in Java, Indonesia, gave private transfers to other households.

Private transfers play an important insurance function in addition to reducing income inequality: they provide old age support and ameliorate the effects of disability, illness, and unemployment. In most developing countries, especially in rural areas, older generations rely on the young to supplement their income. Indeed, ensuring support in old age is one of the reasons for having children. Studies in Kenya and Peru found that more than a quarter of private transfers were given to parents by their children. There is also evidence that households struck with disability, illness, or unemployment receive increased transfers. A study in Peru indicated that the sick receive larger transfers, and studies in both Peru and Indonesia showed that being unemployed significantly increases the probability of receiving a transfer and its amount.

**Public works programs**

Public works programs can complement private efforts to help the unemployed poor, provided the recipients are willing to work for low wages. The low wages act as a self-targeting mechanism, because only the truly needy will accept them. These schemes are particularly appropriate during recessions, when other job opportunities are unavailable. They are also well suited for rural areas during the slack season and can have a secondary benefit of building or maintaining important infrastructure assets. In Ethiopia, for example, program participants have been employed building roads and preventing soil erosion. In the United States, in what was perhaps the most significant use of public works programs as relief among industrial countries to date, the Works Progress Administration provided employment for up to a fifth of all U.S. workers during the Great Depression of the 1930s.

Many developing countries have also made extensive use of public works programs. The Food for Work Program in Zimbabwe and the Emergency Social Fund in Bolivia provide a basic level of employment and consumption for some of the poor. The Employment Guarantee Scheme in the Indian state of Maharashtra uses taxes to redistribute income from the wealthier urban areas, particularly Bombay, to the poor who work in rural areas. Chile introduced large government-financed urban public works programs during the recessions of the mid-1970s and early 1980s. Like the Indian scheme, the Chilean programs' main objective was to create employment: at the bottom of the recession of the early 1980s they absorbed more than 10 percent of the labor force. By December 1988, a year after Chile's vigorous economic recovery, that share had fallen to less than 0.1 percent.

Public works programs tend to have a greater chance of success where labor is more mobile and where there is a tradition of community work. When workers are able to move, the location of the program can be determined.
Private transfers are large in many countries.

Table 13.1 Prevalence and amounts of private transfers in selected countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>GNP per capita (1986 dollars)</th>
<th>Receiving households</th>
<th>Giving households</th>
<th>Receiving households</th>
<th>Giving households</th>
</tr>
</thead>
<tbody>
<tr>
<td>El Salvador (urban poor)</td>
<td>1976</td>
<td>820</td>
<td>33</td>
<td>..</td>
<td>11</td>
<td>..</td>
</tr>
<tr>
<td>India</td>
<td>1975–83</td>
<td>290</td>
<td>93</td>
<td>..</td>
<td>8</td>
<td>..</td>
</tr>
<tr>
<td>Indonesia (Java)</td>
<td>1982</td>
<td>490</td>
<td>31</td>
<td>72</td>
<td>10</td>
<td>8</td>
</tr>
<tr>
<td>Rural</td>
<td></td>
<td></td>
<td>44</td>
<td>45</td>
<td>20</td>
<td>3</td>
</tr>
<tr>
<td>Urban</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kenya</td>
<td></td>
<td>300</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Urban (recent migrants)</td>
<td>1968</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nairobi (urban poor)</td>
<td>1971</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nationwide</td>
<td>1974</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rural</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Urban</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Malaysia</td>
<td>1977–78</td>
<td>1,830</td>
<td>19–30b</td>
<td>33–47b</td>
<td>11c</td>
<td>..</td>
</tr>
<tr>
<td>Mexico (two villages)</td>
<td>1982</td>
<td>1,860</td>
<td></td>
<td></td>
<td>16–21b</td>
<td>1</td>
</tr>
<tr>
<td>Peru</td>
<td>1985</td>
<td>1,090</td>
<td></td>
<td></td>
<td></td>
<td>2</td>
</tr>
<tr>
<td>Philippinesd</td>
<td>1978</td>
<td>560</td>
<td></td>
<td></td>
<td>9</td>
<td>..</td>
</tr>
<tr>
<td>United States</td>
<td>1979</td>
<td>17,480</td>
<td></td>
<td></td>
<td>1</td>
<td>..</td>
</tr>
</tbody>
</table>

.. Not available.

a. Average income includes the incomes of those who did not receive or give transfers. The average transfer received as a percentage of recipients' income is much larger: 39 percent in El Salvador and 9 percent in Peru. Similarly, the average transfer is computed as a proportion of total consumption expenditures.
b. Averages not available; figures denote upper and lower bounds.
c. The average transfer was 46 percent of income for households in the lowest income quintile.
d. Cash gifts in a large informal housing area.

Source: Cox and Jimenez 1990.

mainly by the quality of projects. Poor laborers looking for public jobs are usually willing to relocate, at least temporarily, to obtain them. But low labor mobility makes these programs less effective—some studies have indicated that obstacles to mobility in China have made it more difficult for that country's public works programs to reach the poor. Community participation greatly enhances the probability of success. Studies from Niger and Senegal indicate that communities with a strong tradition of employment pooling can assist in the mobilization of workers and facilitate the production of public goods, for example through local production on common fields for common stockholding or simple neighborhood assistance schemes.

The level of wages in such programs is important in determining their success at targeting the needy. High wages may attract better-off workers and, given limited budgets, lead to fewer jobs being created for the truly destitute. The importance of wage determination for the success of public works programs is demonstrated by the Maharashtra program in India, which seeks to guarantee employment on demand. In its initial fifteen years the program maintained wages on a par with prevailing wages for unskilled casual agricultural labor. But in 1988 wages were increased sharply, in line with a doubling of the statutory minimum wage. The higher wage, combined with budgetary pressures, effectively eliminated the employment guarantee in the year after the wage increase.

Most public works programs have two objectives: providing relief to laborers in distress and creating a public asset. To achieve both, programs must be managed flexibly, to respond to changes in the labor market, and, especially, must have the capacity to expand employment rapidly in time of crisis. This implies the need for a large pipeline of well-prioritized projects. In normal times only a core program of high-return investments should be undertaken. Employment can then be expanded during crises by implementing some of the lower priority projects in the pipeline.

Income security for the formal sector

Risk-sharing provisions are common in formal labor contracts. But private solutions are often inadequate because they cannot insure against economy-wide shocks, and be-
cause of insurance market failures, therefore most governments are involved in the provision of income security to formal sector workers. Getting the design of these programs right is very important. There is great risk that the initial beneficiaries of social insurance—usually the relatively well-off—will gain at the expense of other workers.

Unemployment benefits

Nearly all the industrial market economies, as well as the countries of Eastern Europe and the former Soviet Union, have unemployment benefit systems. These countries face two important questions: how should the systems be financed? and what steps can be taken to ensure that they do not distort incentives and discourage unemployed workers from seeking a job?

From an efficiency perspective, an unemployment benefit scheme should ideally require all workers to pay for their own insurance, by taxing them—or their employers, who would then shift the burden to the workers through lower wages—at different rates related to the probability of their losing their jobs. In practice, however, most countries finance unemployment benefits through a flat payroll tax, which implies that stable employers and their workers finance benefits for more unstable employers. The United States tries to address this problem by using an experience rating system: unemployment insurance is funded through a payroll tax rate that varies according to the likelihood that the employer will cause the benefits to be used, subject to a lower and an upper limit. By raising the cost of unemployment insurance for activities that create more unemployment, an experience rating system provides an automatic link between its outlay and its income and encourages more stable employment patterns. But such schemes are administratively complex.

Generous unemployment benefits may discourage some workers from seriously seeking work or from accepting job offers that fail to meet their aspirations. Countries deal with this problem by changing the time profile and amount of unemployment compensation. The fraction of the salary that is replaced often decreases over the benefit period, gradually increasing the worker’s incentive to find a job. Unemployment insurance offices may require beneficiaries to accept job offers, take training courses, or collect benefits in person, and some make voluntary quitters ineligible for benefits.

Two principles have emerged from the experience of industrial countries with unemployment benefits: benefits should, as far as possible, be tied to job search, and permanent dependency on unemployment benefits should be avoided. Most countries limit the duration of benefits, in the hope that this will shorten unemployment spells and reduce dependency. They usually continue to provide people with basic levels of social assistance when they are no longer eligible for benefits, to ensure that they are not simply thrown into poverty. This type of assistance is sometimes combined with some form of training, in an effort to simultaneously provide income support for the unemployed and increase their probability of reemployment.

Job security regulations

Unemployment benefit schemes are rarely used in developing countries because they are complicated and costly to administer. Instead, many developing countries have introduced job security regulations to make it difficult for firms to lay off workers. Some regulation may be needed to limit unfair practices, but too much can discourage employment creation. Some observers argue that job security regulations in Brazil, India, Peru, and Zimbabwe have made formal sector employers more cautious about hiring permanent workers, slowing the rate of formal job creation. By creating impediments to formal job creation, excessive job security regulation may protect those who are in wage employment at the expense of outsiders—the unemployed and those in the informal and rural sectors.

Job security legislation often tries to discourage arbitrary dismissals by establishing a liability for employers who fire workers without just cause. Mexican law requires employers to give one month’s notice to workers being dismissed and to pay three months’ wages as a minimum severance. In the absence of just cause, the severance increases by twenty days’ wages for each year on the job. This type of formula may create a problem if, as in many countries, the interpretation of just cause extends only to serious misconduct, not to economic causes. In these countries the restructuring of firms tends to lead to sharp labor-management disputes and a significant waste of resources. Disputes often end up in court, introducing uncertainty about the benefits that dismissed workers will actually receive.

Sri Lanka provides another example of job security regulations that may undermine the efficient functioning of the labor market. In addition to requiring employers to make severance payments and provident fund contributions, Sri Lanka’s laws impose tight restrictions on firms’ ability to lay off workers. Firms with more than fifteen workers may not shed labor on nondisciplinary grounds without the concerned workers’ written consent. Firms usually must make large severance payments, beyond what is required by law, to obtain this consent. Under these circumstances it is not surprising that many firms hire workers on a casual or daily basis or rely on subcontracting.

Severance pay

Instead of restrictive income security regulations, many countries address the real concerns of formal sector workers by having firms make lump-sum severance payments to laid-off employees. Ideally, the precise amount should be
negotiated between workers and employers, with some government oversight to ensure equity. The workers benefiting from this insurance would normally pay at least part of the costs, either directly or indirectly through lower wages. But this arrangement is rarely seen; instead, most countries have administratively fixed severance payments, which often are too high. If wages are fully flexible, these high payments may not be a problem, because employers will offset the high cost of firing by lowering wages. If wages are rigid, however, the additional cost may discourage employment. In some countries, employers and workers try to avoid the requirement through fixed-term or daily contracts, which defeat the purpose of the legislation.

The problem with severance pay lies in determining the level of payment that would provide adequate protection to workers without excessively taxing firms that need to shed labor. There is no magic formula for striking this balance, but collective bargaining between employers and free labor unions may achieve a more desirable result than government fiat. Employers and worker representatives should be allowed to bargain over the entire remuneration package and be able to trade more severance pay for lower wages or less agreeable working conditions. Under this framework, labor laws would announce the principle of income security through severance payments and perhaps define a maximum level, leaving the actual amounts to differ across firms. Government’s role would be to ensure that workers’ rights to collective bargaining are protected and help settle disputes. Agreements reached in this way would have a better chance of balancing workers’ desire for security with market realities and would be easier to enforce than legislated severance payments.

Alternatively, governments may decide to make the severance payments themselves and finance them through general revenue. The level at which severance payments are set then have no effect on firms’ employment and wage levels—instead, taxpayers subsidize the affected workers. But this approach has major problems. It provides an incentive for firms and workers to engage in high turnover. It could, for example, encourage firms to fire workers during the slack season and rehire them when activity picks up, letting government pay the firing costs.

Empirical evidence

Many observers believe that the regulations on job security and severance pay adopted in many European and low- and middle-income countries have reduced employment creation. But there are very few empirical studies that substantiate this belief, and fewer still have tried to estimate the magnitude of the effect. Evidence from industrial countries where these regulations are strictly enforced is inconclusive. A 1991 analysis of the declining European steel industry found that stringent job security guarantees on the continent led to fewer job losses than in the more laissez-faire United Kingdom. On the other hand, Spain’s experience with job security regulation provides a strong case in which relaxation led to an expansion of employment. The introduction of a fixed-term employment contract option in 1980 and its expansion in 1984 were associated with faster aggregate employment growth, consisting almost exclusively of people on fixed contracts, than was expected on the basis of past productivity trends and output expansion.

Stringent job security regulations that require firms to obtain prior government consent before laying off workers have been analyzed in India and Zimbabwe. This analysis found that firms in the formal sector could not pass on the cost of job security to their workers because of wage rigidities. Instead, they adjusted to the cost of this regulation by employing fewer workers. The study estimated that, on average, these regulations reduced formal employment in thirty-five Indian industries by 18 percent and in twenty-nine industries in Zimbabwe by 25 percent.

A study of rural labor markets in northeastern Brazil provides further evidence of the possible negative impact of job security legislation. The Brazilian Rural Labor Statute of 1963 required agriculture labor contracts to meet certain minimum standards, including severance pay. This may have led firms to hire temporary (casual) rather than permanent workers. Although total employment in the region increased in the 1960s, permanent employment declined from 45 percent to 39 percent of peak-season employment. The decline was reversed in the 1970s, and the ratio rebounded to 65 percent by 1980. But the study argued that, in the absence of the severance pay regulations, permanent employment would have risen throughout the period. It concludes that the Brazilian legislation may have been counterproductive because it led to a significant reduction in permanent contracts.

Not all studies detect a negative impact of job security and severance pay regulations on formal employment in developing countries. For example, almost all Malaysian firms in an ILO survey stated that job security laws had no impact on their employment. But the potential for negative effects on formal sector employment from high costs of shedding labor has led several countries to reconsider their job security and severance pay legislation. Senegal has revised its labor code, lowering the cost of labor shedding. Argentina added “economic cause” to the list of allowable reasons for dismissal in its job security legislation. In a series of reforms begun in 1978, Chile has consistently limited the payoff workers may receive under court verdicts.

Programs to help those who cannot work

Public works employment and unemployment insurance are irrelevant for those whom disability or old age prevents from working. Disabled and elderly individuals without a
history of formal sector employment rely primarily on family and community-based support mechanisms in most societies. However, some more-formal programs providing transfers to the nonworking poor have had success. Bangladesh’s Vulnerable Groups Development program supplies grain to some half a million rural women and children, focusing on high-risk regions and relying on local leaders to identify the needy. A means-tested scheme for agricultural workers in India’s Kerala State provides a modest pension that supports the cost of home care for the elderly without supplanting strong informal support arrangements.

For formal sector workers and in richer societies, including many transitional countries, formal schemes of social assistance, disability payment, and pensions are often a major source of support for those who cannot work. Disability and pension systems in part take the form of insurance programs, linked to the labor contract by payments made by employers or workers. This linkage of benefits to contributions made by or on behalf of the individual is important; otherwise there are incentives to avoid payments, for example through going informal or casual. This can lead to insolvent schemes and redistributive transfers. Generous pension and disability plans can also provide incentives for individuals to withdraw from work earlier than they otherwise would. A recent World Bank study assessed the problems of linkage and distorted incentives with respect to pensions. It found that many schemes are unviable and that evasion is a major problem in countries such as Jamaica, Rwanda, Uruguay, and Turkey. Many countries in Eastern Europe and the former Soviet Union may be at the beginning of such crises. Another issue is targeting benefits to the truly needy. Means-tested benefits are often used in rich countries but impose heavy administrative burdens. More practical for most low- and middle-income countries are schemes that target an attribute closely associated with need, such as widowhood, single-parenthood, or the presence of a handicap or severe disability.

Most governments are heavily involved in providing income security, despite the risk of discouraging the expansion of formal employment. Many have had good results. Public works programs are often a powerful instrument for providing income security to unemployed informal sector and rural workers, and for complementing community-based arrangements and other basic safety nets for the poor. Low- and middle-income countries with limited administrative capacity do best with schemes based on severance pay for formal workers, preferably negotiated through collective bargaining, rather than unemployment insurance. Experience shows that these different types of schemes, as well as pension systems, are successful when they are largely self-financed, with a close correspondence between those who pay and those who benefit, and when they are designed to minimize incentives to leave the labor force or shift to informal or casual labor contracts.

CHAPTER 14

The Government as an Employer

BIG GOVERNMENT IS OUT OF FASHION. AS countries around the world move toward open markets and less regulation, many are also reconsidering the role of the state in economic life. Although active government is necessary to support market-oriented, labor-demanding development, often this means less government, doing different things than in the past, and doing them better. The size of the government’s work force varies significantly across countries (Figure 14.1). But whereas every country has individual teachers, police officers, bureaucrats, and government clerks who are dedicated and efficient, the civil service as a whole is often regarded as poorly motivated and unproductive. Inspired by the East Asian economies, where efficient civil services have contributed to economic development, developing countries in Africa and Latin America as