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# Social Safety Nets and Structural Adjustment

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**SOCIAL SAFETY NETS AND STRUCTURAL ADJUSTMENT**

**ECONOMICS DEPARTMENT WORKING PAPERS No. 517**

**by Paul van den Noord, Nathalie Girouard and Christophe André**

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## ABSTRACT/RÉSUMÉ

### Social safety nets and structural adjustment

Social safety nets protect citizens against hardship. By offering compensation, social safety nets may help overcome the political resistance to trade liberalisation and structural reform, but they can also weaken the incentives to work and save. Depending on their design, safety nets may also ease or impair adjustment to changing economic circumstances. Against this backdrop, the paper looks at the impact of social safety nets on output and employment and on the ability of economies to absorb adverse shocks. Dependent on their design, the presence of extensive social safety nets is often associated with more limited labour resource use and lower per capita GDP levels, even though activation policy can provide offsets. Moreover, many of the characteristics of social safety nets that reduce output and employment levels heighten the persistence of slack in the wake of adverse shocks. By contrast, the impact of social safety nets on business investment and household saving, and by extension the current account balance, is not clear-cut.

*JEL codes:* E21, E24, E32, O47, F42, O57, H55

*Keywords:* social safety nets, economic convergence, economic resilience, structural policy

\* \* \* \* \*

### Systèmes de protection sociale et ajustement structurel

Les systèmes de protection sociale ont pour but de protéger la population contre certaines difficultés. En offrant une compensation, les systèmes de protection sociale peuvent contribuer à surmonter la résistance politique à la libéralisation des échanges et aux réformes structurelles, mais ils peuvent aussi affaiblir les incitations au travail et à l'épargne. Dans ce contexte, cet article examine l'impact des systèmes de protection sociale sur la production et sur l'emploi et également du point de vue de la capacité d'absorption de chocs négatifs par l'économie. La présence de larges systèmes de protection sociale, selon leur conception, se traduit souvent par une utilisation plus limitée des ressources en main d'œuvre et par des niveaux plus faibles de PIB par habitant, même si les mesures d'activation peuvent avoir un effet compensateur. De surcroît, un grand nombre des caractéristiques des systèmes de protection sociale qui réduisent les niveaux de production et d'emploi accentuent la persistance d'une sous-utilisation des ressources à la suite d'un choc négatif. En revanche, l'impact des systèmes de protection sociale sur l'investissement des entreprises et l'épargne des ménages et, partant, sur le solde de balance courante, n'est pas bien défini.

*Classification JEL:* E21, E24, E32, O47, F42, O57, H55

*Mots clés :* systèmes de protection sociale, convergence économique, résilience économique, politique structurelle

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## SOCIAL SAFETY NETS AND STRUCTURAL ADJUSTMENT

by

**Paul van den Noord, Nathalie Girouard and Christophe André<sup>1</sup>**

### 1. Introduction

1. Globalisation has contributed to the emergence of new geographical clusters of wealth and decline, both within countries and across countries.<sup>2</sup> Social safety nets can play a useful role in this context by facilitating mobility across jobs and regions. Moreover, by protecting citizens against hardship and offering compensation, they can also help overcome resistance against globalisation. For social safety nets to play these roles efficiently, however, their design matters: poor design features will weaken the incentives to work, save and adjust to changing economic circumstances. Against this backdrop, the paper looks at the impact of social safety nets on output and employment and on the ability of economies to absorb adverse shocks.<sup>3</sup> It also briefly addresses political economy issues and the impact of social safety nets on saving and current-account imbalances.

2. The main conclusions can be summarised as follows:

- Social safety nets act as an income shock absorber and as such contribute positively to economic welfare.
- However, dependent on their design, the presence of extensive social safety nets is often associated with more limited labour resource use and lower *per capita* GDP levels, even though activation policy can provide offsets.
- Many of the characteristics of social safety nets that reduce output and employment levels heighten the persistence of slack in the wake of adverse shocks.
- The impact of social safety nets on business investment and household saving, and by extension the current account balance, is not clear-cut. In theory their presence reduces the need for precautionary saving, but the empirical evidence to support this is rather scant.

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1. The authors are members of the Economics Department. The views expressed in this paper are the authors' and are not necessarily those of the OECD or its member countries. The authors are indebted to Sven Blöndal, Jean-Philippe Cotis, Romain Duval, Jørgen Elmeskov, Ekkehard Ernst, Mike Feiner, Stéphanie Jamet, Miguel Jimenez, Mike Kennedy, Vincent Koen, Mark Pearson, Raymond Torres and Andreas Wörgötter for their comments.

2. See for example Venables (2006).

3. The analysis draws heavily on the various OECD *Jobs Strategy* publications, notably OECD (2006b).

- By offering compensation, social safety nets may help overcome the political resistance against trade liberalisation and structural reform. However, to the extent they serve to protect the interests of “insiders” they may also harden political resistance.

## 2. Stylised characteristics of social safety nets

3. In most OECD countries extensive social safety nets are in place. The following characteristics tend to be common to most of them:

- An *unemployment benefit programme*, replacing between 45 and 85% of the earnings losses, with benefits sometimes of long duration. In some countries the expiration of the benefit triggers entitlement for an alternative benefit programme.
- *Incapacity-related benefit programmes*, which provide earnings replacement and care service to workers who become sick or disabled during their working years, either on or off the job. Receipt of benefits for disabled workers is typically characterised by long duration.
- Provisions for *early retirement*, which are often operated as a transition from employment to retirement pensions. The replacement rate is typically lower for early retirement, but in several countries it reaches 70% after age 60.
- A variety of *welfare programmes*, which provide coverage to working-age individuals and families and are often means-tested. These programmes may include child allowances and credits, childcare subsidies, housing allowances and rent subsidies, as well as a minimum income guarantee.

4. Employment protection legislation (EPL) is primarily designed to foster longer-term employer-employee relationships, but it also acts as a shock absorber by shielding workers against job loss and could be seen as an alternative for unemployment insurance. Therefore EPL has features in common with social safety nets that are relevant in the context of this paper (see Box 1).

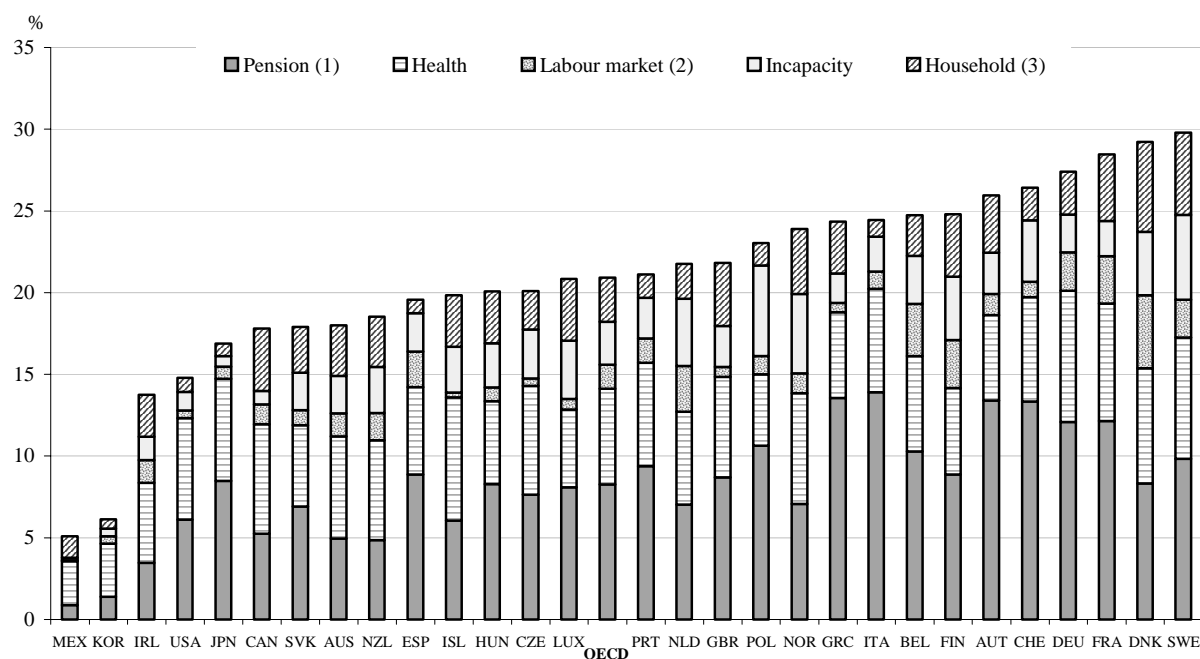
5. Safety nets are expensive but they are only a subset of social expenditures, which also include health care and pension spending, thus totalling 22% of GDP for the OECD area as a whole (Figure 1, upper panel). Social expenditures exhibit rather large cross-country variation, with most European countries well above the average in terms of both spending and the number of benefit recipients (Figure 1, lower panel). However, social expenditure, as usually defined, may not accurately reflect the extent of social support in OECD countries. Elements such as taxes paid by beneficiaries of welfare benefits, tax breaks for social purposes and social benefit schemes provided on a mandatory basis by the private sector should also be included. Once seen in such a wider perspective the cross-country dispersion in social expenditures is markedly reduced<sup>4</sup> (see Box 2).

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4. After correcting for these additional factors, the standard deviation of social spending as a share of GDP drops from over 7½ to 5½ percentage points. If non-mandatory private social spending is also included, differences tend to become even smaller.

**Figure 1. Social expenditure programmes**

Gross public social expenditure, per cent of GDP, 2001

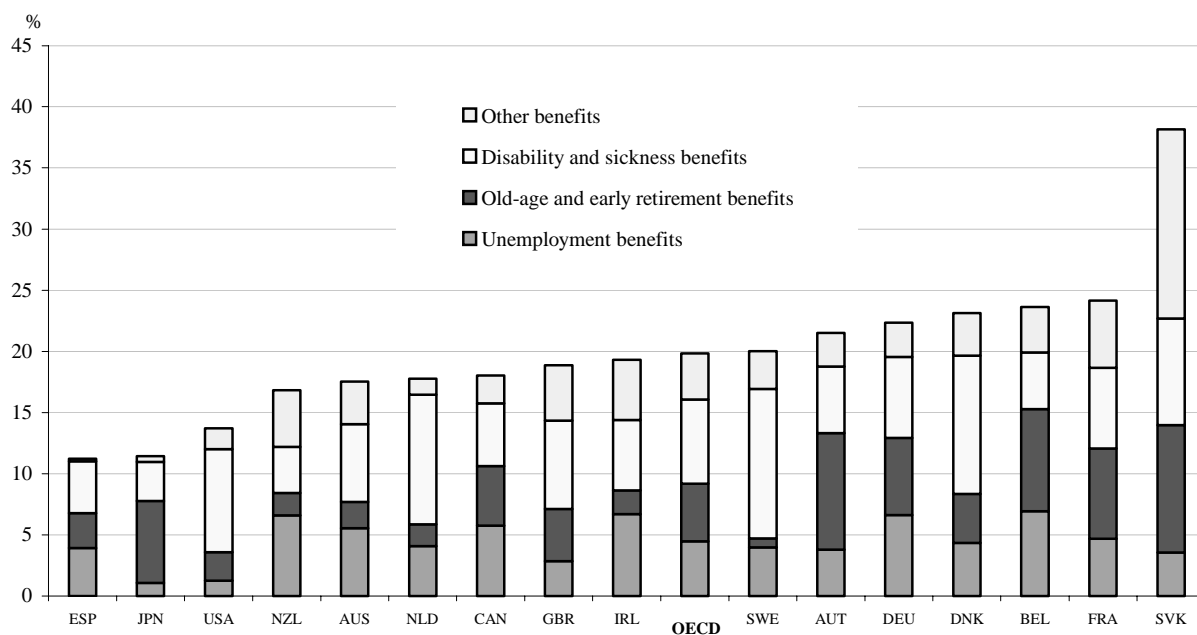


1. Old-age and survivors' benefits.
2. Unemployment benefits and active labour market policies.
3. Family, housing and other social expenditure.

Source: OECD Social Expenditure database 2004.

**Beneficiaries of welfare benefits**

Percentage of working-age population, 1999



Note: OECD is the unweighted average for the countries shown. Countries are shown in ascending order of benefit dependency rates. 1999 is the last year for which data are available.

Source: OECD, Boosting jobs and incomes (2006).

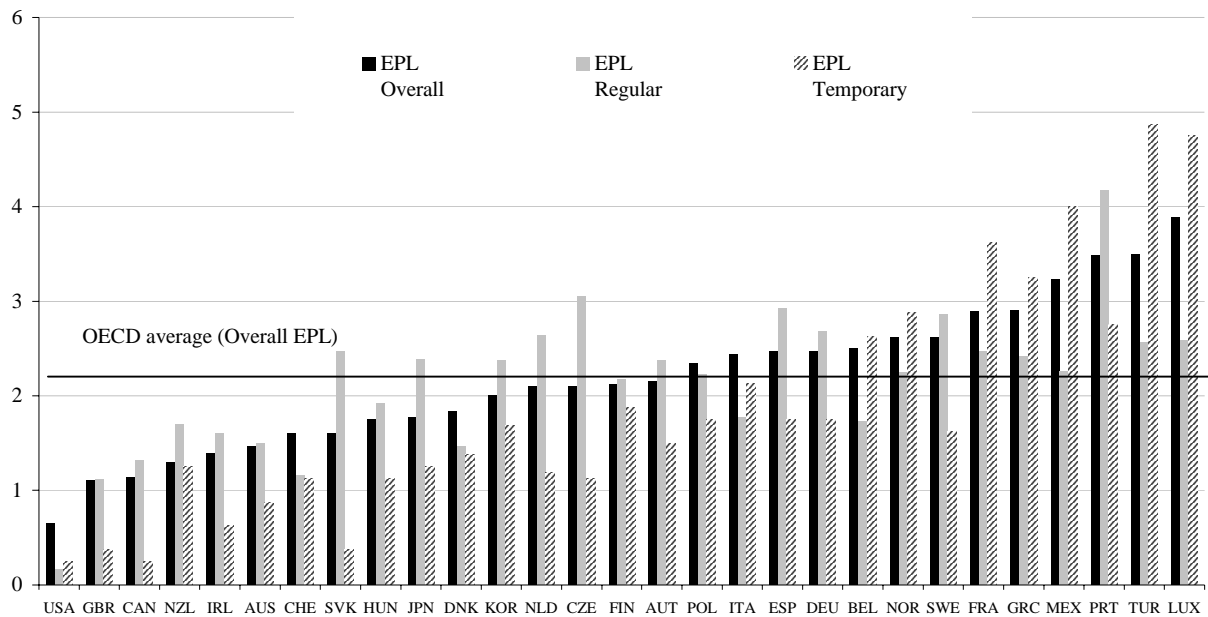


**Box 1. Employment protection legislation and macroeconomic performance**

Employment protection legislation (EPL) aims to provide workers with protection against job loss and as such it could be considered as a social safety net in the face of adverse shocks. Since EPL constrains the ability of employers to adjust the size of their work force in response to changes in the demand for their output, an employment contract becomes a fixed cost for the employer, generating a negative impact on hiring decisions.

**Employment protection legislation**

Index scale of 0-6 from least to most restrictive, 2006



Source: OECD Secretariat.

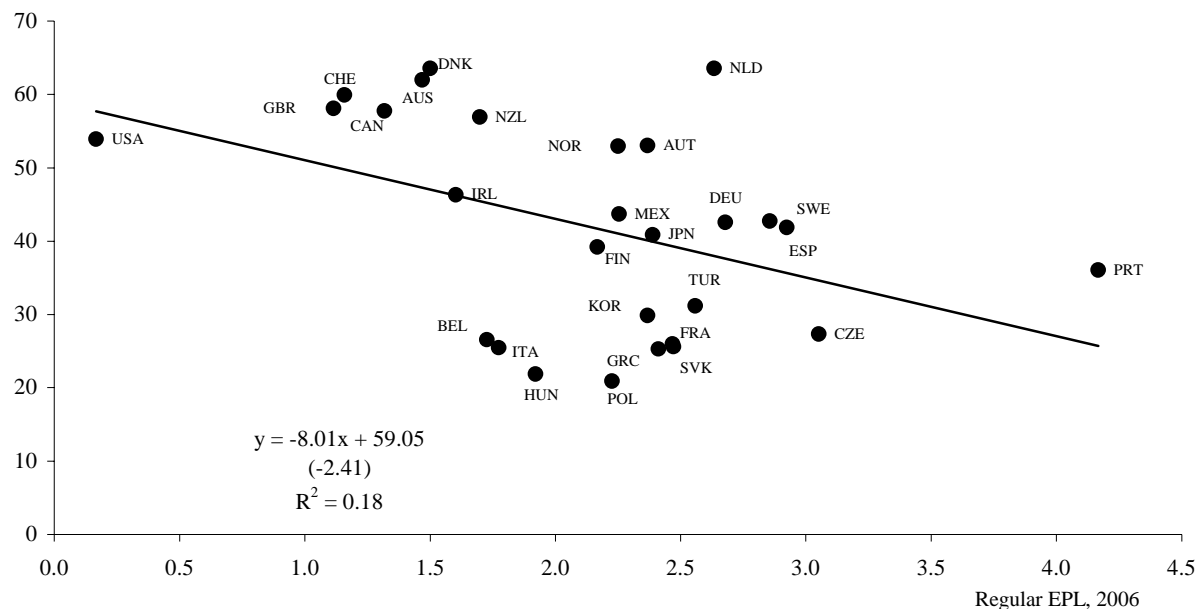
Mostly southern European and some Nordic countries are characterised by comparatively strict EPL both for regular and temporary employment contracts (see figure above). The empirical evidence on any direct effects of EPL on the overall employment rate is scant. Even so, strict EPL is deemed to worsen the job prospects of new labour market entrants and, *a fortiori* of the young, by reducing job turnover and hiring (first figure below). Stringent EPL is also found to be detrimental to other aspects of economic performance, such as the adoption of new technologies, as these typically require the adjustment of workforces.

The lower job turnover associated with strict EPL implies an increase in the average duration of unemployment and the proportion of long-term duration of unemployment. This reduces the responsiveness of real wages to unemployment and hence diminishes the resilience of economies in the face of adverse shocks (as suggested by the second figure below). Reform of EPL in several European countries during the past decade has been geared towards easing of regulations affecting temporary contracts, with little change on regular contracts. This has been accompanied by a substantial increase in the share of temporary jobs in total employment (Germany, France, Italy, the Netherlands, Portugal and Spain). While these developments may have contributed to lowering labour adjustment costs, the burden of adjustment has become more heavily concentrated on temporary workers, increasing the wage bargaining power of “insiders” and possibly further reducing the responsiveness of real wages to shocks.

**Box 1. Employment protection legislation and macroeconomic performance (continued)**

**Regular EPL and youth employment**

Employment rate 15-24, 2005

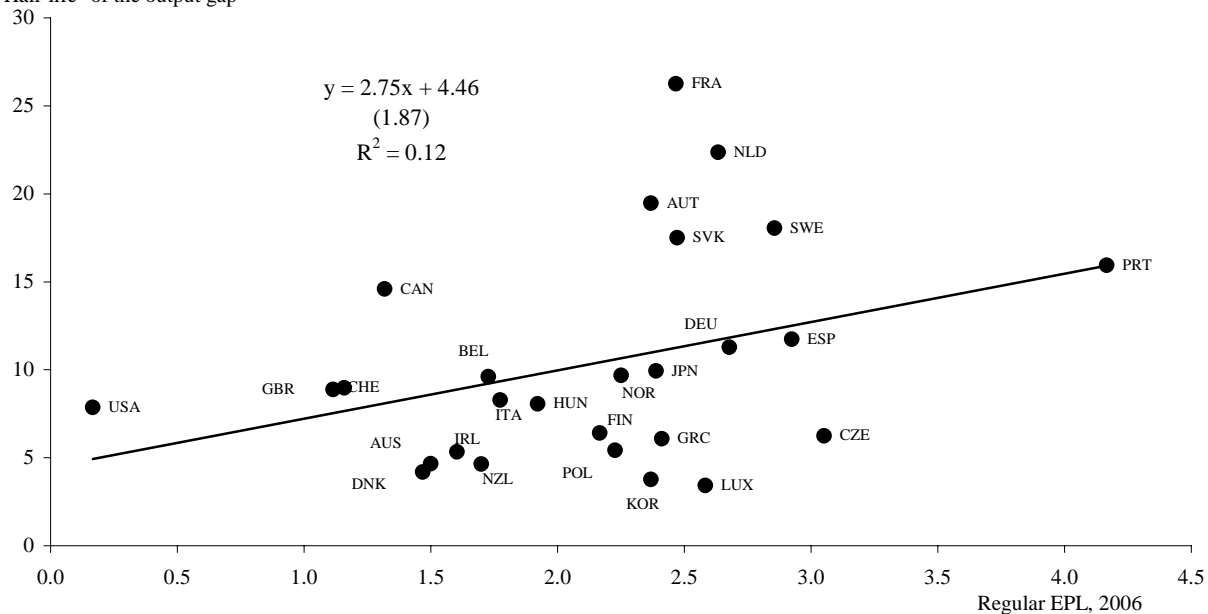


Note: The regression statistics would only be slightly affected by the removal of the outliers (USA and PRT).

Source: OECD Secretariat.

**Regular EPL and resilience**

"Half-life" of the output gap



Note: For the calculation of the half-life of the output gap, see figure 7, note 3. The regression statistics would only be slightly affected by the removal of the outliers (USA, PRT and FRA).

Source: OECD Secretariat and OECD calculations.

**Box 2. Comparing social expenditure across OECD countries: measurement issues**

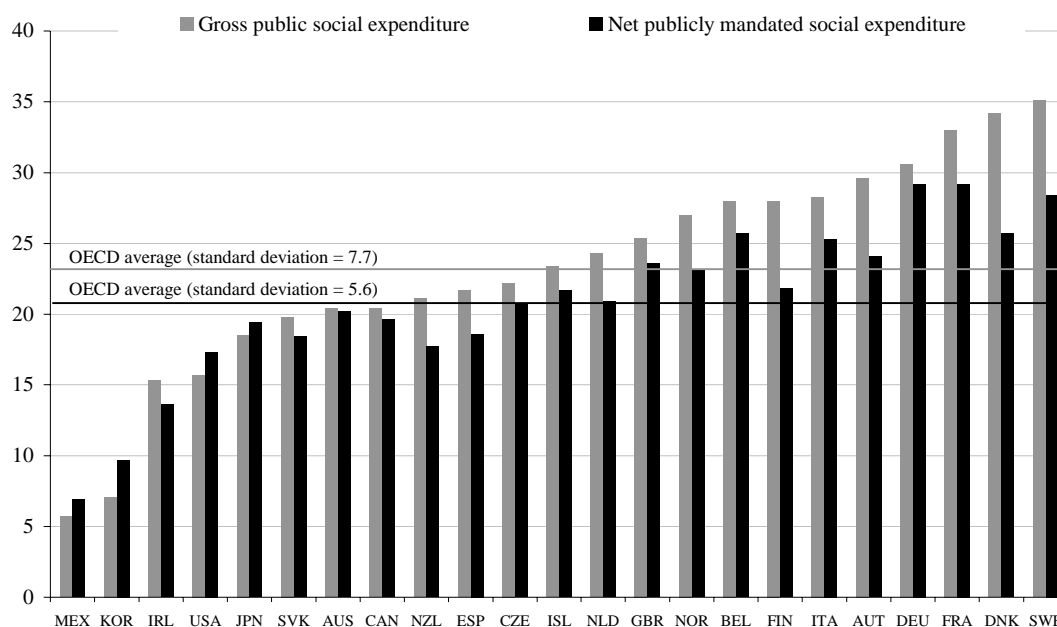
Gross public social expenditure to GDP ratios are often used for comparison of welfare states. However, this approach does not give a full picture of collective social efforts across countries to the extent that mandatory private social expenditure and the impact of tax systems on the value of social expenditures are not accounted for.

Mandatory private social expenditure covers social benefits which legislation forces employers to provide. Adding these to public social expenditure yields a total for gross publicly mandated social expenditure. There are three features of tax regimes that can further affect social expenditure: *i)* governments can levy direct taxes and social security contributions on cash transfers; *ii)* governments can levy indirect taxes on goods and services bought by benefit recipients; and, *iii)* governments can also pursue social policies through the tax system by giving tax relief that is either similar to cash benefits, or by awarding tax advantages aimed at stimulating the provision of voluntary private social benefits. By subtracting the first two sets of items from and adding the third set of items to gross publicly mandated social expenditure, the net publicly mandated social expenditure indicator accounts for these effects and provides a picture of what resources are truly publicly earmarked for social expenditure.

The figure below shows how the various corrections affect the measure of social expenditure. There are a few cases where countries portray a significantly different score dependent on whether the gross public or net publicly mandated measure is used. More generally, the differences between countries tend to diminish when net publicly mandated social expenditure is used as the relevant measure, with the standard deviation falling from 7½ percentage points for gross public social expenditure to 5½ percentage points for net publicly mandated social expenditure. It is also noteworthy that, due to the inclusion of “tax expenditure” items, net publicly mandated social expenditure can be higher than gross public social expenditures. This is notably the case in the United States, Japan, Korea and Mexico.

**Gross public and net publicly mandated social expenditure**

Per cent of GDP, 2001



Source: Adema and Ladaique (2005).

### 3. Effects of social safety nets on output and employment levels

6. Social safety nets pursue important social objectives, but can have negative effects on economic performance as poorly designed social protection appears to create obstacles to labour market participation and job creation. This helps explain why the convergence of per capita income towards the United States level has stalled in a number of OECD countries (Figure 2).<sup>5</sup> The significant social costs associated with this failure have brought renewed attention to the influence of institutions and policy setting on longer-term growth performance.<sup>6</sup>

7. The following features of extensive social safety nets are often found to have a negative impact on employment rates and GDP *per capita*:

- Unemployment compensation systems offering high benefits and, in particular, entitlement of long or indefinite duration, have the potential to impede the adjustment of real wages to labour market conditions and to create large supply distortions by reducing job-search intensity and lowering the opportunity costs of not working.<sup>7</sup> If well designed, activation policies may help to offset these adverse incentives to some extent, see below.
- The interaction of social protection benefits and taxes on labour can create unemployment or inactivity traps, especially for low-productivity workers who qualify for social benefits and have very little financial incentives to enter employment.<sup>8</sup>
- Eligibility criteria built into disability programmes to the extent these are unrelated to health offer early labour market exit routes. As a result, the high numbers of disabled in several countries have less to do with their health situation than with their disability benefit coverage (Figure 3).<sup>9</sup>
- Retirement systems also offer early exit routes to workers, underpinned by powerful financial incentives (Figure 4, upper panel). Promoting labour market exit of older workers in the pursuit of low unemployment, while expensive, is likely to be ineffective: low participation of older workers typically goes along with high unemployment (Figure 4, lower panel).<sup>10</sup>

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5. See Arjona *et al.* (2002) and OECD (2005a, 2006a). Most continental European countries have even been diverging rather than converging since the mid-1990s, although this appears to be mostly related to divergent patterns in labour and total factor productivity associated with a slow pick-up of new technologies and strict product market regulation, see for example Nicoletti and Scarpetta (2005).

6. See OECD (2006b) and the various OECD *Jobs Strategy* publications.

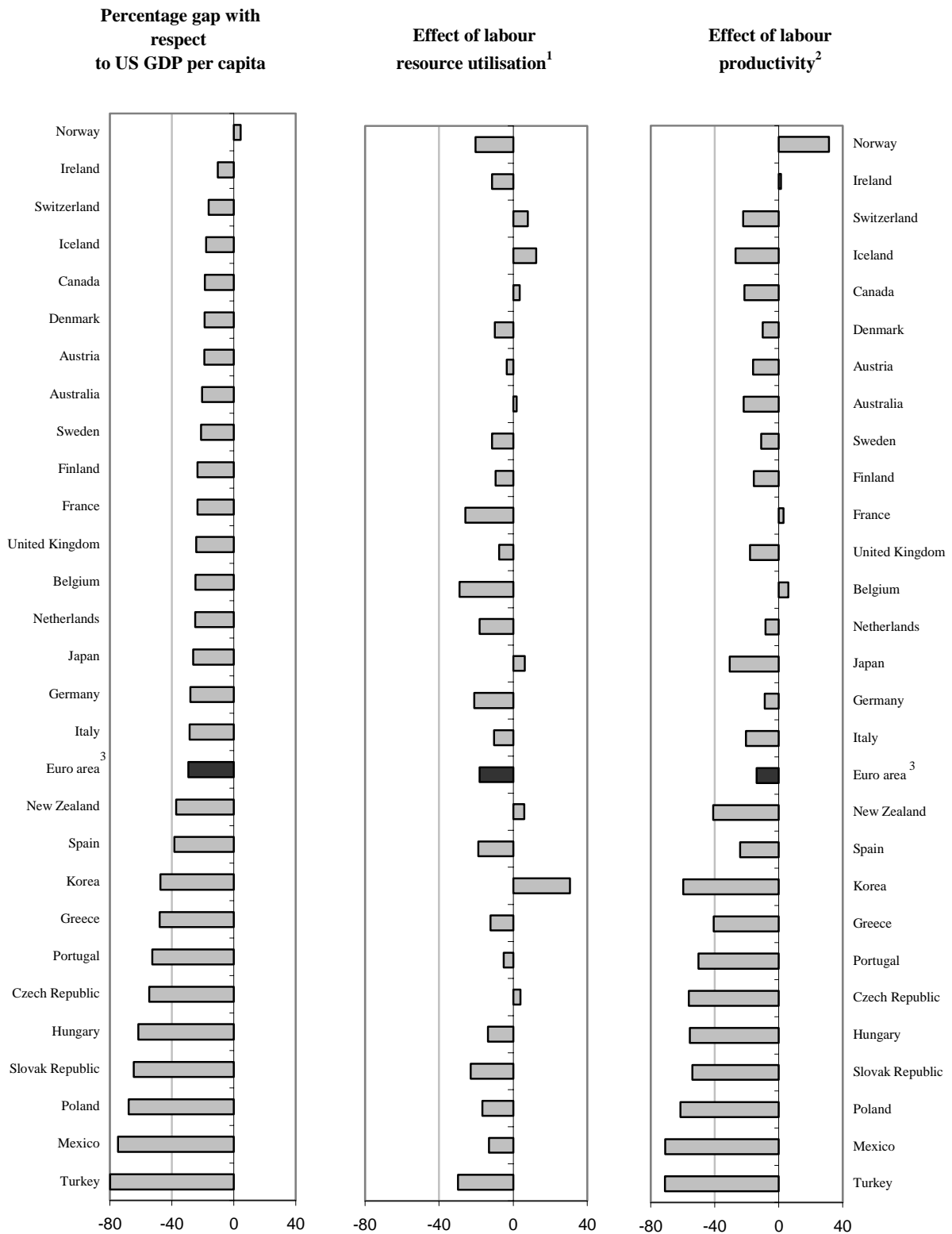
7. See for instance Bassanini and Duval (2006), Nickell *et al.* (2005), Nunziata (2003), Jimeno and Rodriguez-Palanzuela (2002) and Elmeskov *et al.* (1998).

8. See OECD (2006b). In-work benefits and tax relief may help to unlock these traps and promote participation for low-paid work, see Immervoll *et al.* (2005). A drawback is that those already in work may reduce their work efforts at pay levels in the phase-out range of the benefits or relief.

9. For cross-country empirical evidence see OECD (2003) and Bonato and Lusinyan (2004).

10. This finding does not imply causality running from participation of older workers to unemployment. Rather, the correlation is likely to reflect political economy linkages in the opposite direction. See Duval (2003), Bassanini and Duval (2006) and OECD (2006c).

Figure 2. The sources of real income differences, 2004



1. Labour resource utilisation is measured as total number of hours worked divided by population.

2. Labour productivity is measured as GDP per hour worked.

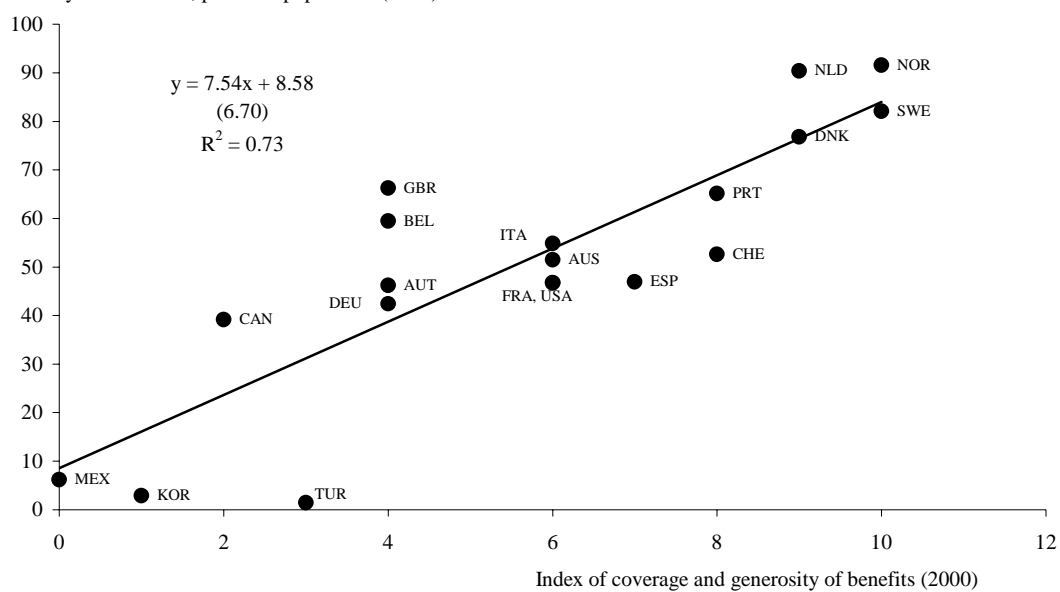
3. Excluding Luxembourg,

Source: OECD National Accounts of OECD Countries, 2005 and OECD Economic Outlook database.

**Figure 3. The generosity of benefits and the number of disability beneficiaries are correlated**

Benefit coverage and generosity vs benefit reciprocity outcome

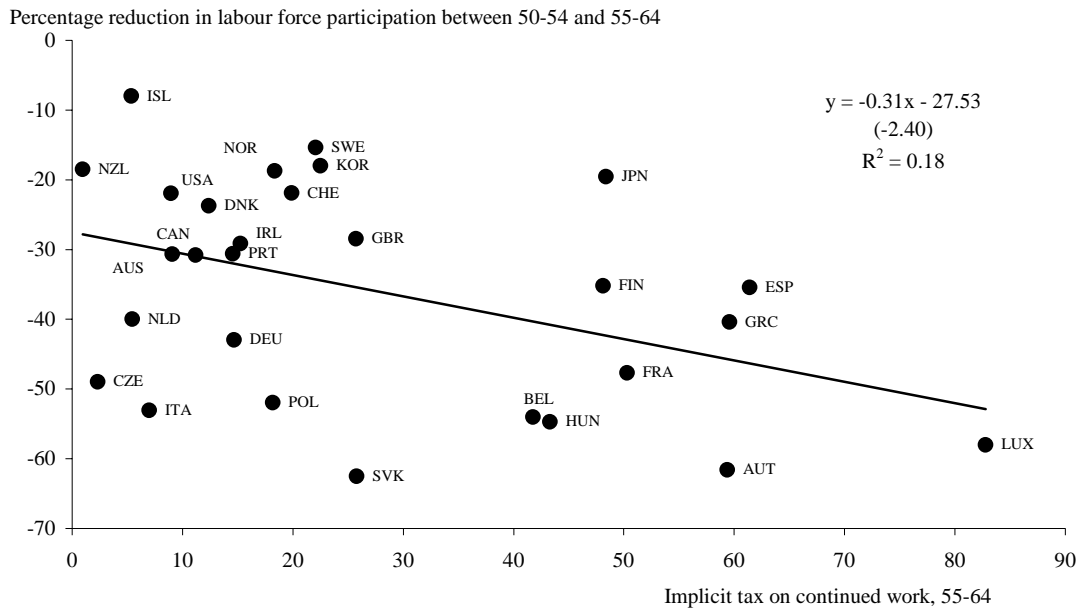
Disability beneficiaries, per 1000 population (1999)



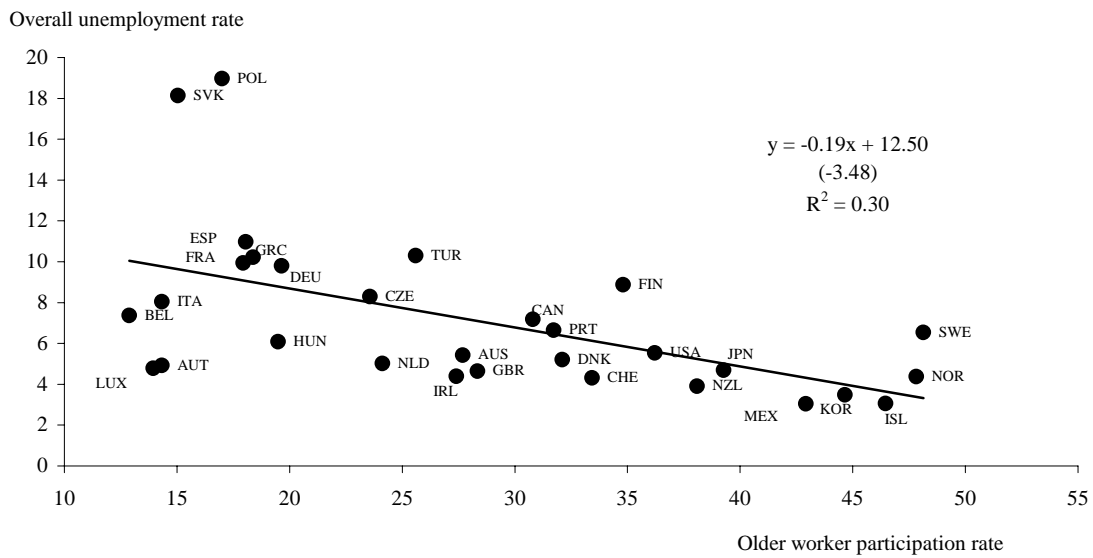
Source: OECD (2003).

**Figure 4. The early retirement fallacy**

**Labour market withdrawal and implicit tax rate, 2004**



**Older worker participation and overall unemployment, 2004**



Note: The regression statistics would only be slightly affected by the removal of the outliers (LUX in the upper panel, SVK and POL in the lower panel).

Source: OECD Employment Outlook 2006 and OECD Taxing Wages database.

8. The fact that social safety nets are often used to pursue income redistribution objectives potentially gives rise to efficiency-equity trade-offs. Descriptive analysis using inequality measures based on household disposable income, suggests that four different models of policy settings can be identified (Table 1):<sup>11</sup>

- First, several English-speaking countries as well as Japan and Korea combine relatively lean social safety nets with strong labour market performance, but face greater income inequality associated with the lower degree of social protection.
- Second, most Northern European countries have achieved equally favourable employment outcomes, at least in terms of number of persons employed if not their working hours, but this is coupled with a comprehensive safety net and small income inequality.
- Third, a number of countries in Continental Europe display low income inequality but their labour resource use is below the OECD average, both in terms of labour market participation and number of hours worked per person.
- Fourth, the transition countries combine unfavourable employment outcomes and large grey economies with, in most cases, more limited social safety nets. Several southern European countries also fall in this category.

Table 1. **Four models of social protection**

	OECD unweighted average	High employment outcomes		Low employment outcomes	
		English-speaking countries, mainly <sup>b</sup>	North European countries, mainly <sup>c</sup>	Countries of continental and southern Europe, mainly <sup>d</sup>	Countries of eastern Europe <sup>e</sup>
Employment protection legislation	2.0	1.4	2.1	2.7	1.8
Generosity of unemployment benefit system <sup>f</sup>	27.8	18.2	39.9	36.2	9.7
Active labour market programmes <sup>g</sup>	29.3	15.8	64.1	25.8	3.5
Tax wedge <sup>h</sup>	27.1	18.5	27.4	34.3	32.4
Employment rate	67.1	70.9	71.9	62.5	58.0
Unemployment rate	7.5	5.3	4.8	9.0	15.1
Total LMP expenditures <sup>i</sup>	1.9	1.0	2.7	2.6	0.8
of which ALMP expenditures <sup>j</sup>	0.8	0.4	1.3	0.9	0.2
Income inequalities (Gini index) <sup>k</sup>	29.3	31.5	25.6	29.8	31.3
Relative poverty rate <sup>l</sup>	9.6	11.8	7.8	9.9	7.0

a) This country classification is derived from a Principal Component Analysis which helps to identify existing combinations of policy settings and to highlight similarities and differences across countries. However, some countries are barely representative of the group of countries to which they belong, being close to the frontier between two regimes of labour market functioning. This is for instance the case for Austria, Finland, Germany, Ireland, Japan, Korea, Portugal, Sweden and Switzerland.

b) This group of countries includes Australia, Canada, Japan, Korea, New Zealand, Switzerland, the United Kingdom and the United States.

c) This group of countries includes Austria, Denmark, Ireland, the Netherlands, Norway and Sweden.

d) This group of countries includes Belgium, Finland, France, Germany, Italy, Portugal and Spain.

e) This group of countries includes the Czech Republic, Poland and the Slovak Republic.

f) Average unemployment benefit replacement rate across two income situations (100% and 67% of APW earnings), three family situations (single, with dependent spouse, with spouse in work), over a five-year period of unemployment.

g) ALMP expenditures per unemployed workers as a percentage of GDP per capita.

h) Tax wedge between the labour cost to the employer and the corresponding net take-home pay of the employee for a couple with a dependent spouse and two children earning 100% of APW earnings.

i) Total expenditures on active and passive measures as a percentage of GDP.

j) ALMP expenditures as a percentage of GDP.

k) Gini index for total population. Not available for Korea and the Slovak Republic.

l) Calculated as the proportion of the population with income below 50% of the current median income. Not available for Korea and the Slovak Republic.

Source: OECD Employment Outlook (2006).

11. This typology is taken from OECD (2006b).



9. This classification, notwithstanding a certain arbitrariness, suggests that different degrees of interventionism may lead to similar outcomes. Notably the Nordic countries have been relatively successful in offsetting some of the detrimental effects of their extensive social safety nets by activation policies, in particular by making unemployment compensation conditional on job search and training. While high spending on active labour market policies will not by itself boost employment rates, the experience in the Nordic countries suggests that well designed active labour market policies can make a difference (Figure 5).<sup>12</sup>

10. However, extensive social safety nets need to be financed and econometric research provides strong evidence that high labour tax wedges reduce labour resource use.<sup>13</sup> Accordingly, the negative cross-country relationship between employment and average tax wedges depicted in Figure 6, upper panel, suggests that higher employment outcomes are associated with low average tax wedges among the English-speaking countries while Continental European countries combine higher average tax wedges with below-average employment rates.<sup>14</sup> The Nordic countries, along with the Continental European countries, exhibit higher marginal tax rates on labour and fewer hours worked than the English-speaking countries and Japan (Figure 6, lower panel).<sup>15</sup>

#### 4. Effects of social safety nets on resilience

11. Several forces are acting to produce long-lasting change in the structure of OECD economies, most prominently technological change and the emergence of developing non-OECD countries and transition countries specialising in manufacturing goods.<sup>16</sup> Social safety nets relying on passive income transfers are less effective in dealing with such “permanent supply shocks”, as opposed to “temporary demand shocks” stemming from *e.g.* investment and stock cycles.<sup>17</sup> As a result, unemployment spells and

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12. There could be a pay-off to extending activation measures to those receiving non-employment benefits, such as sickness and disability, but so far this potential is hardly being exploited, including among the Nordic countries where the coverage, levels and the numbers of recipients of disability and sickness benefits are highest, see OECD (2003), Bonato and Lusinyan (2004), Carcillo and Grubb (2006) and Rae (2005).

13. See for example Bassanini and Duval (2006), Jimeno Rodriguez-Palanzuela (2002), Blanchard and Wolfers (2000), Daveri and Tabellini (2000), and Elmeskov *et al.* (1998).

14. Tax systems are also biased against second earners in (mostly southern) Continental European countries. Tax incentives to work part-time are more widespread in English-speaking countries than in Continental European economies. Family support policies are sometimes used to offset these tax disincentives.

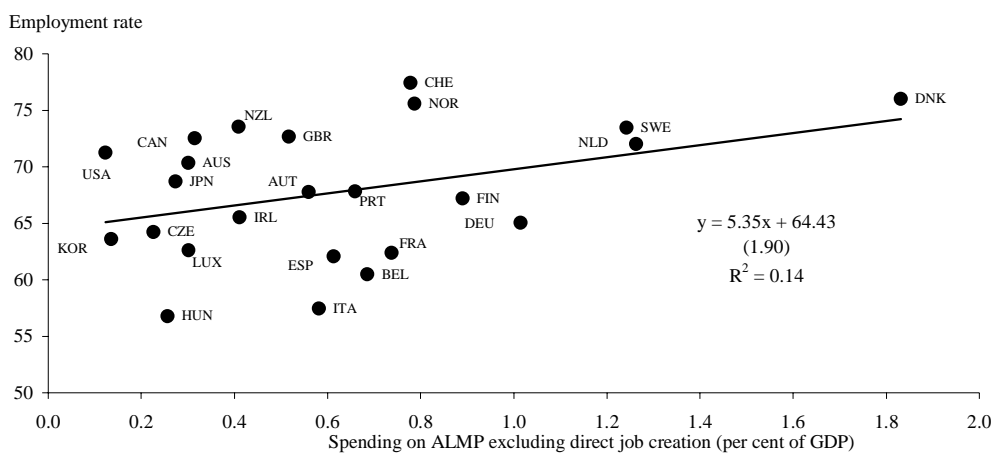
15. This reflects not only that social safety nets are leaner among the English-speaking countries, but also that they are to a larger extent financed by – more broadly-based – general tax revenues, as opposed to social security tax that is primarily levied on labour income. However, this feature may have adverse implications for household saving behaviour in English-speaking countries, see the next section.

16. These factors have, in different guises, been acting on the most developed countries for centuries. See OECD (2005b).

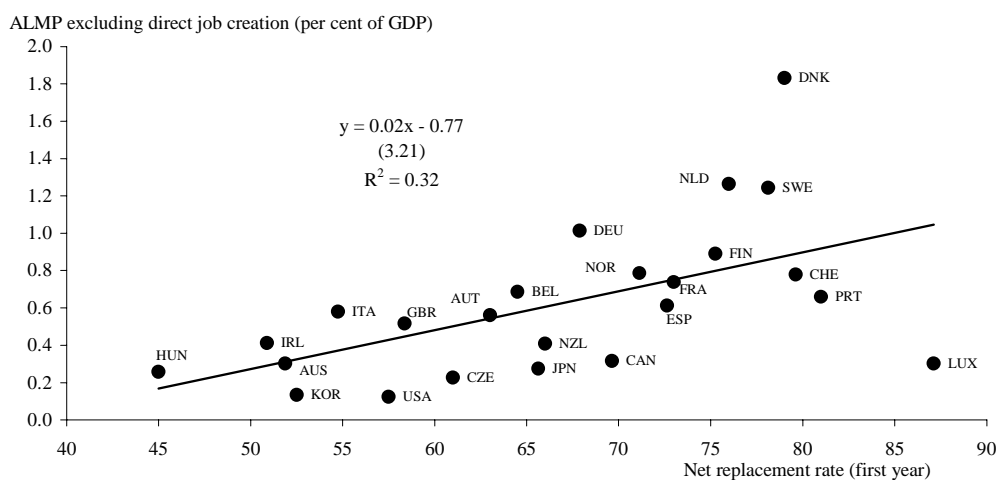
17. In economies that are strongly exposed to foreign trade and participate in a monetary union with their main trading partners, competitiveness losses stemming from the operation of social safety nets may in fact wipe out the entire stabilisation effect following supply shocks -- see Buti and Van den Noord (2005).

Figure 5. Work disincentives and activation policies

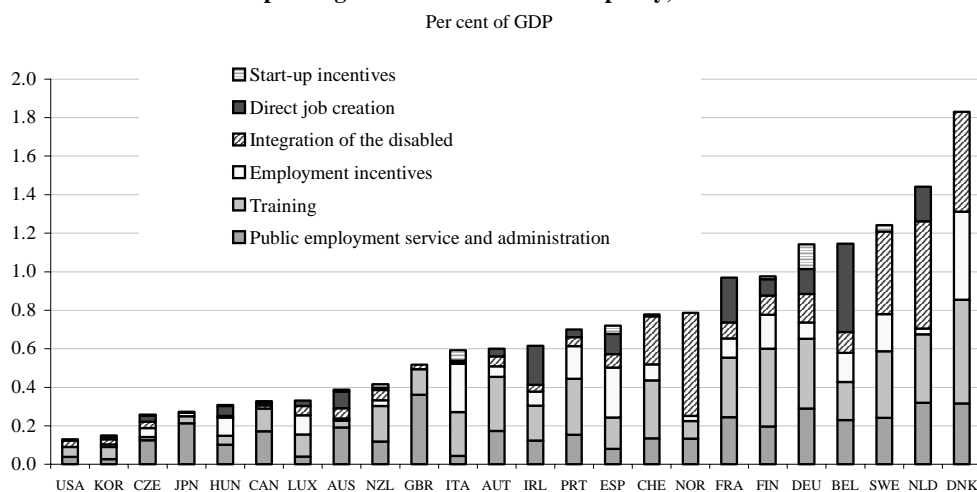
Employment rate and active labour market policies, 2004



Net replacement rate and active labour market policies, 2004



Spending on active labour market policy, 2004

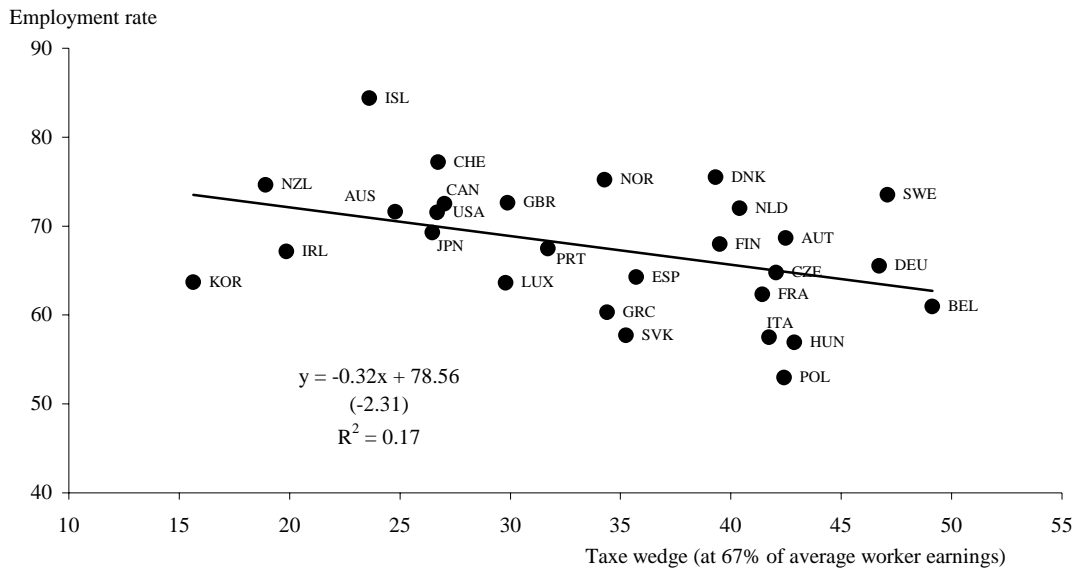


Note: In the upper panel, the removal of the Nordic countries and the Netherlands would make the statistical relationship insignificant. In the middle panel, the removal of Denmark would not alter significantly the regression statistics.

Source: OECD Employment Outlook 2006.

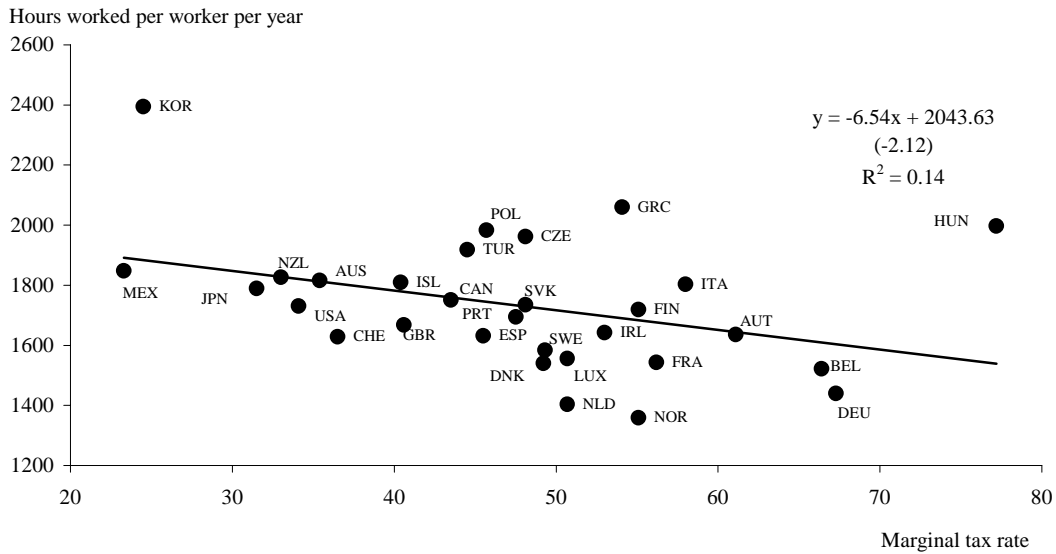
**Figure 6. Fiscal (dis-) incentives to work**

**Employment rate and labour tax wedge, 2005**



**Hours worked and marginal tax rate, 2004**

At 100% of average wage



Note: The regression statistics would only be slightly affected by the removal of the outliers (ISL, POL and KOR in the upper panel, HUN and KOR in the lower panel).

Source: OECD Employment Outlook 2006 and OECD Taxing Wages database.

the associated welfare losses may increase, not least since net replacement rates can be close to or even exceed 100% of wage earnings in a typical new job for workers moving from declining manufacturing industries to expanding (service) activities.<sup>18</sup>

12. Social safety nets prevent or reduce hardship in downturns and as a result contribute to mitigating the impact of the business cycle.<sup>19</sup> However, if poorly designed, they also allow people affected by changing economic circumstances to delay adjustment and therefore may lead to a greater persistence of below-par activity in the wake of shocks. This suggests the possibility of a trade-off between cushioning the initial impact of shocks (stability) and the capacity to rebound after shocks (low persistence or resilience). Indeed, over the period 1995-2005, which covers the global upswing of the late-1990s and the subsequent global downturn, persistence of slack, as gauged by the “half-life” of the output gap, has tended to be stronger in countries where the variability of economic growth has been lower and social safety nets were more extensive (Figure 7).<sup>20</sup>

13. Econometric panel studies carried out since the mid-1990s indeed generally confirm that social safety nets are potentially costly in terms of persistence of high unemployment and below-par activity after an economy has been hit by an adverse shock.<sup>21</sup> Many of the characteristics of social safety nets that affect persistence overlap with those that impinge on potential output and employment levels. Accordingly, several empirical studies have found evidence that countries with low estimated output gap persistence include the group of English-speaking countries and Nordic ones.<sup>22</sup> By contrast, output gaps are found to be highly persistent in large continental European countries as well as in Japan.

## 5. Effects of social safety nets on saving and external imbalances

14. Social safety nets affect countries’ external positions insofar as they influence saving and investment. Such impacts may arise through a number of channels including labour supply, international capital flows and household saving.

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18. See Kongsrud and Wanner (2005) who find net replacement rates in unemployment benefit schemes of workers who have lost a job in a high-paying manufacturing sector to exceed 100% of the earnings of a corresponding new job in services sectors with low wage premia in France and Spain.

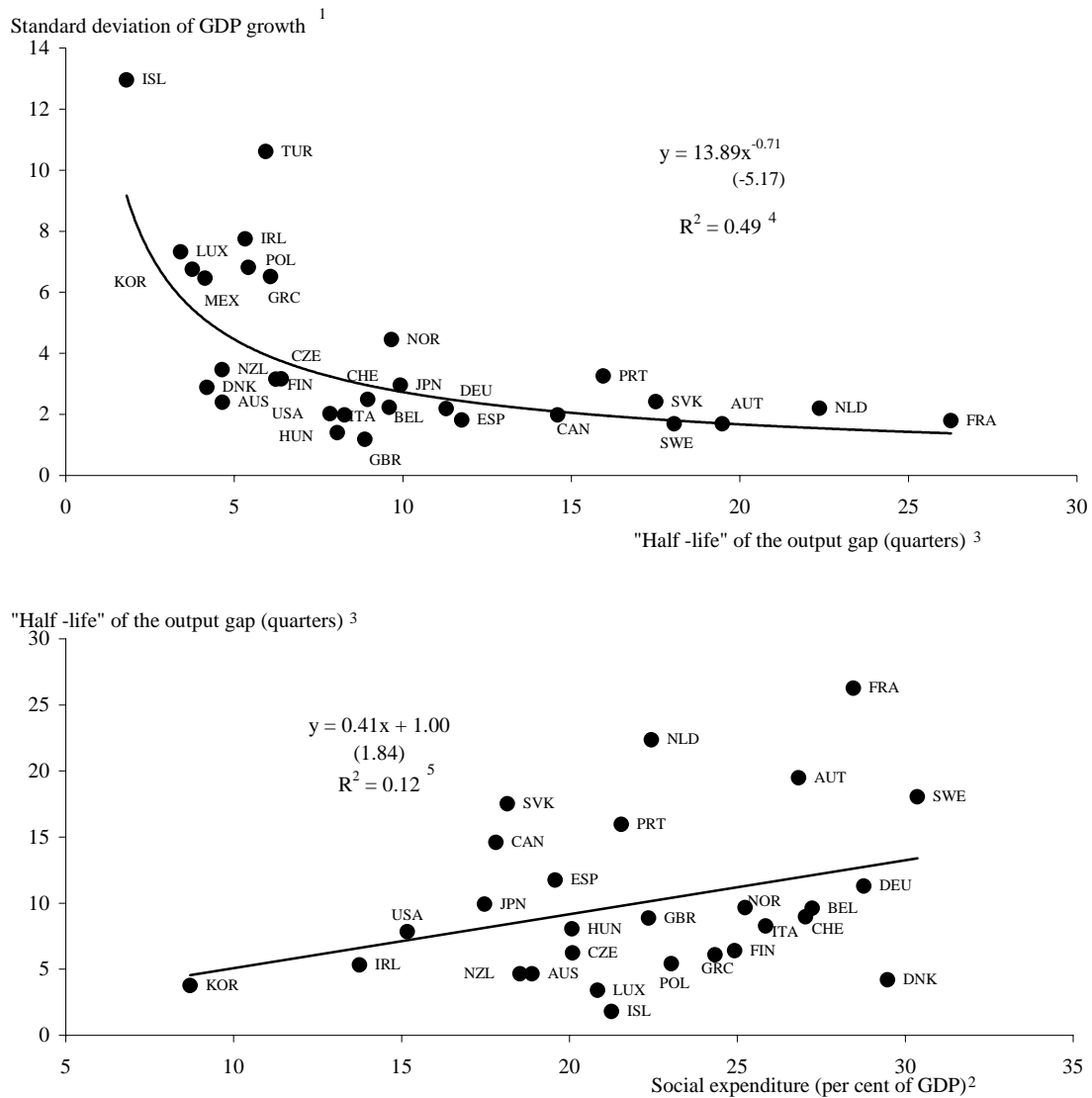
19. Insofar as social safety nets commit public funds via social expenditure programmes, the mechanisms are equivalent to the well-known fiscal automatic stabilisers. A necessary condition for these to be effective is that the government faces fewer liquidity constraints and a lower risk premium than households and therefore can be more efficient at consumption smoothing over the cycle than households are -- a condition which is broadly met to varying degree across countries, see Van den Noord (2002).

20. Cross-country dynamic panel estimates of the short-term vulnerability to common shocks and the persistence of these shocks generally confirm this finding, see Duval (2006). This property could be replicated by a general equilibrium modelling exercise embedding stylised behavioural relationships for the United States and euro area economies, with the former showing high variability and resilience and the latter low variability and resilience, see Drew *et al.* (2004).

21. Blanchard and Wolfers (2000) finds that higher replacement rates, stricter EPL and a higher tax wedge lead to significantly persistent high unemployment in the wake of an adverse shock. Similarly, Scarpetta (1996) finds a significant effect on persistence from unemployment benefit rates and EPL. These results have been confirmed in recent reassessments and updates reported by Bassanini and Duval (2006) and Duval (2006).

22. See for an extensive discussion, Cotis and Coppel (2005).

Figure 7. The trade-off between stability and resilience



1. Based on quarterly growth, seasonally-adjusted annual rates, on the period 1995-2005.
2. Social expenditure include public and private mandatory social expenditure. The data are for 2001.
3. The half lives of the output gap (GAP) reported in this figure are derived from a set of regression equations estimated for the period 1995-2005 (quarterly data) for each country separately which have the following form:

$$\Delta GAP_t = \sum_i \delta_i \Delta GAP_{t-i} - (1 - \rho)GAP_{t-1} + \gamma + \varepsilon_t$$

where  $\Delta$  is the first difference operand,  $\delta$ ,  $\rho$  and  $\gamma$  are estimated coefficients and  $\varepsilon$  is the error term. The parameter  $\rho$  can be shown to be exactly equal to the sum of the regression coefficients  $\sum_i \beta_i$  of the autoregressive process:

$$GAP_t = \sum_i \beta_i GAP_{t-i} + \gamma + \varepsilon_t$$

with the half life approximated as  $\ln(1/2)/\ln\rho$ .

4. The regression statistics would only be slightly affected by the removal of the outliers (ISL, TUR, FRA and NLD). The removal of countries with high quarterly GDP volatility does not significantly affect the results.
5. The coefficient is significant at the 10% level and becomes insignificant if outliers (KOR, FRA and NLD) are removed. The removal of countries with high quarterly GDP volatility does not significantly affect the results.

Source: OECD Social Expenditure database 2004 and OECD Economic Outlook 79 database.

15. Policy that makes social safety nets leaner in one country is akin to increasing its effective labour supply relative to the rest of the world. With a less than fully elastic domestic demand for labour, this entails a fall in the country's relative wages and prices as well as an increase in the profitability of domestic capital. This is likely to initially improve the current account position of the deregulating country, but over time the increase in profitability is likely to attract capital from the rest of the world, reversing the initial trade effect on the current account through an appreciation of the real exchange rate. However, the empirical evidence for such pattern linking safety nets to the current account, is still rather scant and inconclusive.<sup>23</sup>

16. *A priori* the relationship between safety nets, including pay-as-you-go systems, and saving is not clear-cut.<sup>24</sup> Theory suggests three categories of saving motives for households: *i*) to provide resources for retirement and bequests; *ii*) to finance expected large life-time expenditures (housing, education); and *iii*) to finance unexpected losses of income and smooth consumption. Safety nets such as unemployment and other welfare benefits tend to act as a substitute for precautionary saving since they provide insurance against negative income shocks. The impact of such systems on saving (assuming that they operate on a pay-as-you-go basis) is less straightforward, however, since saving propensities depend on the age structure of the population. Pay-as-you-go systems will prompt less saving of prime-age households but also less dissaving of ones at retirement age. In this context, although past studies have found a negative impact of safety nets on private sector savings in OECD countries,<sup>25</sup> it is not obvious that these conclusions will hold in the future. OECD long-term projections suggest indeed that paradoxically pay-as-you-go systems may contribute to mitigate the spontaneous fall in saving associated with ageing: having been low savers in the past, baby-boomers should become low dissavers in the future.

17. Conversely, a combination of lean safety nets<sup>26</sup> and a relatively young population would call, *ceteris paribus*, for comparatively high household saving. This is not however what is observed in English-speaking countries. One factor, among many others,<sup>27</sup> that may help explain this pattern is the mode of financing of social benefits in these countries. If tilted towards progressive income tax (as opposed to flat-rate and capped social security tax in Continental Europe), it shifts the financing burden to higher incomes, which may lower aggregate saving. This is indeed a distinct feature of English-speaking countries, whereas financing through social security contributions as in many continental European countries is more saving-friendly.<sup>28</sup> The more heavy reliance on wealth-testing built into the social safety nets in English-speaking countries may further reduce the incentives to save out of low incomes.

18. One issue that is of importance for a benign unwinding of global current account imbalances is the extent to which the development of safety nets and social protection could impact on household saving in emerging economies, in particular China. A high level of saving relative to GDP in China in part may reflect the limited nature of the safety nets and social protection, especially in the area of unemployment

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23. See Kennedy and Sløk (2005).

24. Over the long term, there is little doubt, however, that safety nets, including pay-as-you-go systems, have a negative impact on capital accumulation.

25. See for instance the pioneering contributions of Munnell (1974) and Feldstein (1974). See also the studies by Alessie and Kapteyn (2001), Borsch-Supan (2001), Rossi and Visco (1995), Callen and Thimann (1997) and De Serres and Pelgrin (2002).

26. Safety nets are referred here in a loose and extensive manner, including health care and pension systems.

27. A wide array of factors such as strong wealth effects, easier access to credit, etc., may explain the low saving rates experienced by English-speaking countries.

28. See for empirical evidence Callen and Thimann (1997).

benefits, health care and retirement pensions in rural areas. Some changes have been made in these policy areas but, due to their limited scope, they are unlikely to substantially reduce saving. Moreover, the reform of the public pension system, while necessary, includes features that are likely to boost saving, both because replacement rates have been reduced and supplementary defined contribution systems introduced. Overall, the development of the social safety net thus seems unlikely to have a major impact on saving in the medium term.

## **6. Social safety nets and the political economy of structural reform**

19. Reforming social safety nets has proved to be difficult. Most countries have tightened work-availability requirements and eligibility criteria for unemployment benefits, or made eligibility conditional on enrolling in training, voluntary work or a subsidised job in return for more intensive job-search assistance, but with a few exceptions (Denmark, the Netherlands) progress has been piecemeal. This suggests that political economy forces may work against reforming social safety nets.

20. Conversely, social safety nets impinge on the political economy incentives for governments to embark on structural reform in other areas. On the one hand, by providing compensation for rent losers, safety nets may help governments to overcome resistance against reform and ease the terms of the inter-temporal trade-off between long-term gain and short-term pain facing elected officials.<sup>29</sup> On the other hand, extensive social safety nets may support political constituencies against structural reform. Empirical work indicates that the causal chain of structural reform typically runs from liberalisation of international trade and investment over domestic product markets and finally to labour markets.<sup>30</sup> This suggests that whatever role social safety nets may play for reform in other fields they may themselves need to continuously adapt to developments in other policy settings.

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29. Notably in the Nordic countries high social protection have helped to mitigate the exposure to risk associated with globalisation, see Rodrik (1998).

30. See Høj *et al.* (2006) and Duval and Elmeskov (2005).

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