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Preferences for social protection: Theory and empirics

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ABSTRACT

Empirical cross-country evidence suggests that countries position themselves along a sort of Market Regulation (MR)-Social Expenditure (SE) trade-off "line". Theoretically, it is clear that there exists a certain degree of substitutability between SE and MR, since both can provide a cushion against socio-economic risks. However, market regulation is an inefficient means to provide protection, since it might reduce productivity and the employment level. Still, to be politically viable efficiency-enhancing deregulation policies must come along with appropriate fiscal measures (social protection spending) to compensate the losers of reforms or to accommodate any temporary negative effect on aggregate demand. This implies that the political determinants of MR and SE should be jointly analyzed to explain both the multiplicity of stable combinations of MR and SE empirically observed, and the strong political resistance often encountered in the implementation of structural reforms. The focus of this paper is a theoretical and empirical (using microdata from the International Social Survey Programme (ISSP)) investigation on the socio-economic, institutional and cultural factors which shape voters' preferences for MR and SE and determine the relative salience of the two political issues. Such an analysis should provide fundamental pieces of information to carry out a proper analysis of the political process to give account of the multiplicity of combinations of MR and SE empirically observed.

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1. Introduction

The literature on the macro impact of market rigidities suggests that countries characterized by a relatively liberal approach in both labor and product markets perform better in terms of productivity and employment (Blanchard and Giavazzi, 2003; Feldman, 2008; Fiori et al., 2007; Messina, 2006; Pissarides, 2003). Nevertheless, the depth, the scope and the timing of deregulation reforms have differed considerably across countries, and, despite the commonly recognized inefficiency of labor and product market regulation, the implementation of structural reforms has often encountered substantial political resistance (Høj et al., 2006).

The point we make in this paper is that the political viability of deregulation policies, should be analyzed taking into account the political sustainability of fiscal measures directed to compensate the losers of reforms or to accommodate any temporary negative effect on aggregate demand. This implies that the political determinants of market regulation (MR) and social protection expenditure (SE) have to be jointly analyzed.

It is theoretically clear that there exists a certain degree of substitutability between SE and MR. Actually, both MR and SE can provide protection against socio-economic risks: while SE serves insurance purposes against the effects of income loss, through the provision of unemployment benefits, health care, education, active labor market policies and so on, MR protects some workers and some firms from unfair market developments. The difference between these two social insurance systems is also clear: MR protects those who already have a job and/or firms which are already in the market at the expenses of outsiders, but does not impose any tax burden; differently, SE provides insurance to the population at large, being typically financed by direct and indirect taxes and social contributions.[2]

Empirically, a first macro-level clue of substitutability between such policies emerges by investigating the relationship between MR and SE across-countries.[3] A clear negative relationship between MR and SE as a share of GDP exists on a world scale. This correlation is particularly pronounced ($R^2 = 0.40$) when we consider social expenditure net of old age pensions while it is even more sloped excluding also health expenditure[4] (Fig. 1). Focusing on the more homogeneous pool of

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[2] On average at EU level in 2010, social contributions accounted for 56% of all social protection receipts while government contributions, financed through taxes, represented 40% of the total. These values hide large national differences in the structure of social protection funding, with Denmark and Ireland financing social spending mainly through general taxes (European Commission, 2012).

[3] The precise definition of variables is reported in Appendix A.

[4] In practice, the aggregate includes benefits for family/children, unemployment plus housing and social exclusion not elsewhere classified, including income support.

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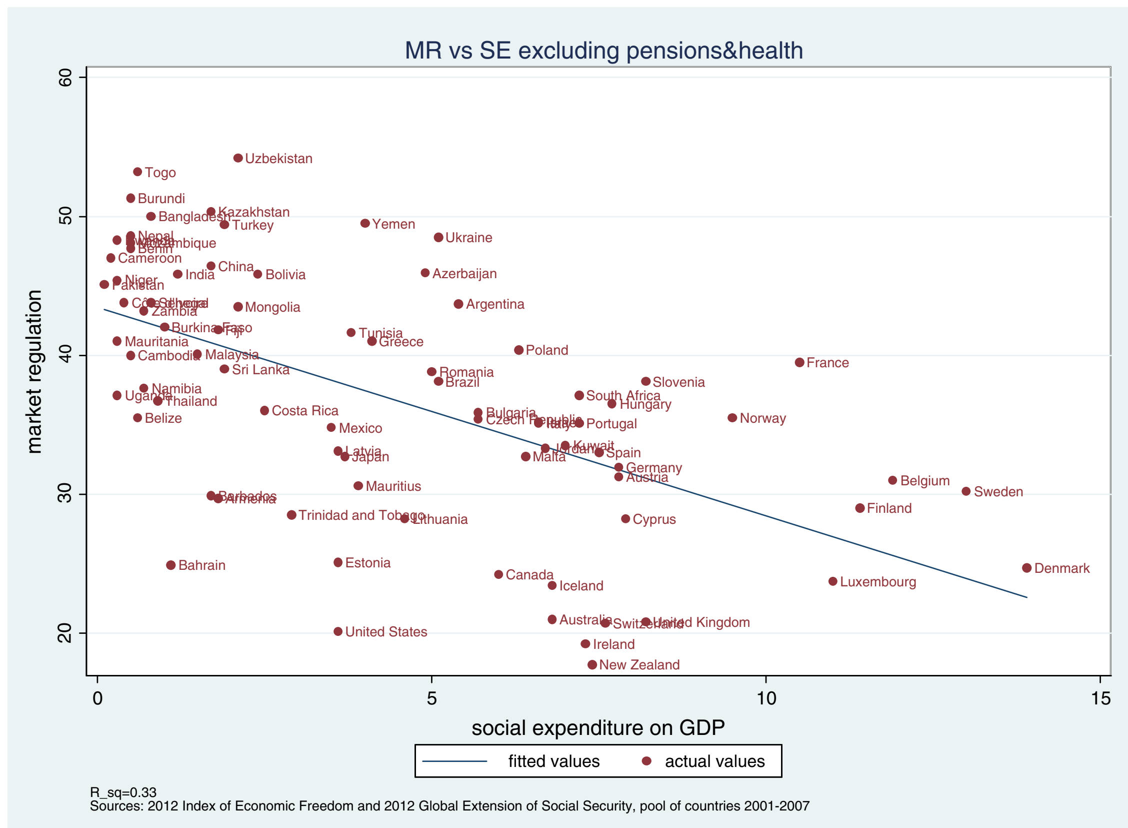

Fig. 1. Correlation between MR and SE as a share of GDP on a world scale (2001–2007).

OECD countries at different points in time (1998 and 2008), Fig. 2 confirms the existence of a substitution between product market regulation (PMR) and social expenditure (net of old age pensions expenditure) as a share of GDP.[5] Finally, on the same OECD sample (years 2008–2009), by restricting the definition of SE to the unemployment expenditure (UB), a negative relationship with PMR still holds (Fig. 3, left panel), while there is no evidence of a substitution between index of strictness of employment protection legislation (EPL) and UB[6] (Fig. 3, right panel).

The evidence summarized in the figures above suggests that countries position themselves along a sort of MR-SE trade-off "line". Two crucial questions here emerge: first, how to explain the multiplicity of stable combinations of MR and SE empirically observed and, second, given the commonly recognized inefficiency of market regulation, why so many countries (mainly, Southern Europe countries) find so difficult moving down-right along the trade-off line. To answer both these questions a political economy analysis would be appropriate. In our view, however, such analysis should be preceded by an investigation of what are the institutional, cultural and socio-economic factors which shape voters' preferences for MR and SE and determine the relative salience of the two political issues. Such an investigation thus constitutes the focus of this paper.

To this goal, we have built a simple theoretical model in which individual preferences for market regulation and social expenditure – which includes only unemployment benefits– are explicitly related to socio-economic factors such as income level and the degree of exposure to unemployment risk. Specifically, individuals' income heterogeneity generates conflicting political preferences about the generosity of social expenditures. Those having a higher-than-average income should support a reduction in social spending, whereas those having lower-than-average income should support an increase of it. However, considering vulnerability to income loss, this general result can be mitigated by the individuals' demand for social protection. In general, the higher the risk of unemployment, the higher workers' demand for a safety net and therefore the more favorable individuals will be to SE. However, the risk of unemployment differs among workers: for more vulnerable workers, the safety net provided by social expenditure can only mitigate the devastating effects of job deprivation and, certainly, does not provide them with full insurance. For these workers, the demand for insurance might take the form of a call for labor and product market regulation which, limiting the scope of competition, reduces the risk of job loss and increases job tenure. On the contrary, less vulnerable workers should oppose market regulation, since it reduces their opportunities to bid for new jobs.

The definition of vulnerable individuals is the object of a debate in the labor market literature. According to Iversen and Soskice (2001), vulnerable workers are characterized by skills specific to a job, firm or sector. In case of an adverse shock, they may lose their job and have difficulties finding a new occupation or may have to accept re-employment into a job where their skills are not fully utilized, causing them a greater damage than the one suffered by individuals equipped with general and more portable skills. This argument is questioned by Goldthorpe (2000) and Emmenegger (2009). More specifically, Goldthorpe's reasoning, shifting the focus on the supply-side of the labor market, implies that employees with very specific skills are difficult to replace. Consequently, they are less concerned about their job security than employees with few specific skills. Thus, according to Goldthorpe only the latter should be considered vulnerable workers.

[5] OECD countries' different attitude towards job protection vs. public social expenditure is discussed in D'Orlando and Ferrante (2009) using a behavioral economic approach.

[6] Compared to other studies which find evidence of a trade-off between UB and EPL such as Boeri et al., 2012, our computations are based on a more recent wave of OECD data and consider the years 2008–2009 instead of mid-nineties.

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