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**Social Protection as
Social Risk Management:
Conceptual Underpinnings
for the Social Protection
Sector Strategy Paper**

**Robert Holzmann
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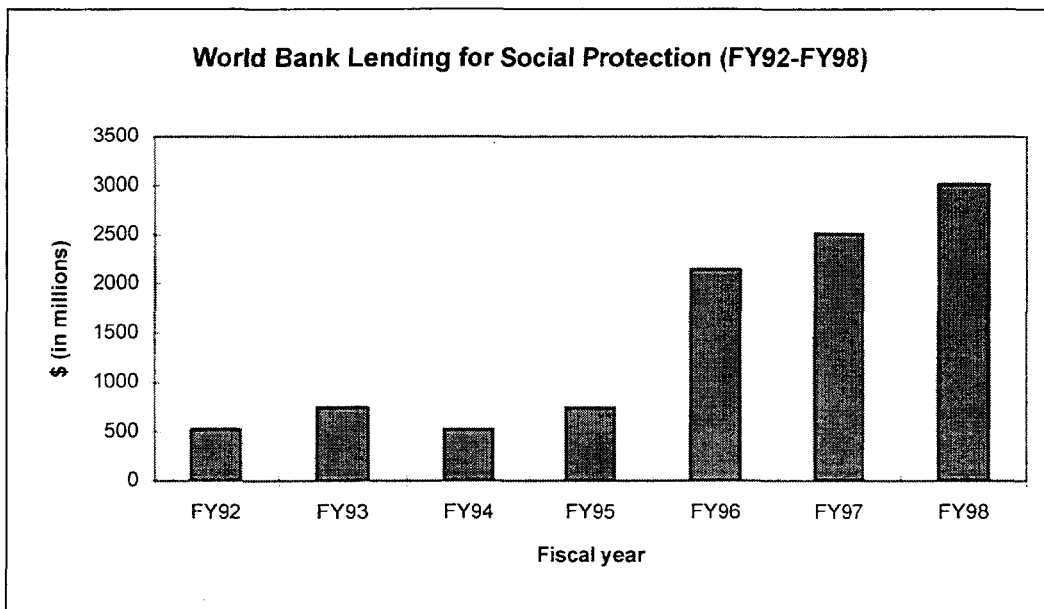
The revolutionary idea that defines the boundary between modern times and the past is the mastery of risk: the notion that the future is more than a whim of gods and that men and women are not passive before nature.

Peter L. Bernstein (1996): Against the Gods – The remarkable story of risk.

I. Background

The Social Protection Family of the World Bank is scheduled to develop its Sector Strategy Paper (SSP) by the fall of 1999. This is an opportunity for the sector to take stock of its accomplishments and to develop the strategic thrust of the Bank's future work in this area. This note serves as a conceptual background piece for this work, and is currently being used as background for the development of regional social protection (SP) strategy papers.

SP is a young, but very dynamic portfolio of the World Bank. While elements of SP have always been present in Bank activities, recent economic developments have brought the need for appropriate social safety nets, labor market programs, and retirement income schemes into sharper focus. These include the restructuring of Eastern Europe begun in the early 90s, the enhanced emphasis on poverty reduction in the recent years, and the current financial crisis in East Asia. As a result, Bank lending in the social protection area has increased nearly six-fold since 1992 with a lending volume of \$ 3015 billion in FY98, amounting to over 13 percent of total Bank lending. An important shift has been towards the increasing use of policy-based lending (e.g., Russia, Kazakhstan, Korea, and Brazil).



Source: World Bank

The lending and non-lending activities by the World Bank in the SP area cover a wide range of activities, including:

- crisis support for the poor;
- development of job placement offices and retraining programs;
- the technical and financial support of pension reform in many countries; and
- conceptual work on labor standards, child labor, and disability.

While all of these activities fall clearly within the domain of SP, a convincing conceptual framework which links those programs together credibly is only slowly emerging. Yet such a conceptual framework is required if past activities are to be appropriately assessed and compared, current activities improved upon, and new activities better designed. The development and presentation of such a conceptual framework is the purpose of this note. This exercise is an ongoing process in which each draft reflects feedback from the World Bank's regional, policy and research departments, and feedback from clients, international partners and academic institutions. Feedback and comments should be sent to either of the authors.

To develop the conceptual underpinnings, the objectives and instruments of SP are viewed under the rubric of Social Risk Management (SRM). SRM consists of public measures intended to assist individuals, households and communities in managing income risks in order to reduce vulnerability, improve consumption smoothing, and enhance equity while contributing to economic development in a participatory manner.

To support the approach and its logic, the structure of this note is as follows: Chapter 2 sets the stage and presents global trends, definitions and outlook. Chapter 3 presents key issues of SRM, from the reasons for World Bank concern to a typology of strategies and instruments and ends with the role of the main actors. Chapter 4 focuses on the boundaries of SP/SRM and on three key policy issues to balance equity, efficiency and political sustainability. Chapter 5 ends with preliminary list of ways in which the new framework may effect our view of SP and the development of new and better instruments.

II. Setting the stage: global trends, definitions and outlook

A. Global trends and increases in risk

Recent trends in the evolution of trade, technology, and political systems have created great opportunities for improvements in welfare around the world. Globalization of trade in goods, services, and factors of production has the world community poised to reap the fruits of global comparative advantages. Technology is helping to speed innovation and holds the potential to remove the major constraints to development for many people. Political systems are increasingly open, setting the stage for improved governance by holding those in power accountable to larger segments of the population. Combined,

these trends create a unique opportunity for unprecedented social and economic development.

The other side of the coin, however, reveals that the exact same processes that increase the opportunity for welfare improvements also increase the variability of the outcome for society as a whole and even more so for specific groups. This was demonstrated on a worldwide scale in 1998 with the global financial crisis. There is no certainty that any such improvements will be widely shared across individuals, households, ethnic groups, communities, and countries. Increased trade or better technology can increase the differences between

the “have” and “have-nots” just as it can increase the opportunity for all, depending on the social context into which it is introduced and the policy measures taken. Globalization-induced increases in income variability combined with marginalization and social exclusion can, in fact, increase the vulnerability of major groups in the population.

In other words, the risks are as large as the potential rewards. To further complicate matters, the trend towards globalization and the higher mobility of production factors also reduce the ability of Governments to raise revenues and pursue independent economic policies and, thus, to have national policies when they are needed most. This three-part challenge is the background for a strategy of Social Protection. This strategy paper will outline what governments can and should do to help individuals, households, and communities to better manage income risk and, most importantly, what the World Bank can and should do to support these efforts.

B. What is Social Protection and what should it do?

Social Protection (SP) consists of public interventions to assist individuals, households and communities in better managing income¹ risks. The objectives of these interventions are a subset of the overall development objectives of economically sustainable participatory development with poverty reduction. Specifically, SP seeks to:

¹ Ultimately the goal for individuals and households is to optimize welfare through appropriate consumption choice, including availability of basic goods and services. As a policy variable we are concerned with income, its level and variance, because both determine the consumption possibilities in a free choice setting, and it is a variable we can help influence. We use the widest possible definition of income including in-kind, imputed income etc. This broad definition takes care of concerns about social services which cannot readily be bought on the market and uses monetary equivalents for analytical purposes (see Section IV.B).

Issues for Poverty Reduction

“The key issue for the early part of the next century is how to bridge [the] gap between opportunity and risk. The challenge for policy makers is the design and implementation of institutions, mechanisms and policies at various levels to harness the potential for poverty reduction, by setting a long term course which will access global and local opportunity but allow broad sharing of the gains from development, while managing the short term risks of inequality, vulnerability, marginalization and social dissolution. This is not an easy task, and crucially important will be learning from a detailed evaluation of experiences with actual interventions in the past. It is important to go beyond broad strategies, to draw lessons for implementation which take into account time horizons and social constraints that policy makers actually face.”

Source: Ravi Kanbur, Staff Director of World Development Report 2000 on Poverty (1998).

- Reduce the vulnerability of low-income households with regard to consumption and access to basic services;
- Allow for better consumption smoothing over the lifecycle for all households and, consequently, for more equal welfare distribution of households;
- Enhance equity particularly with regard to the exposure to shocks and the effects of shocks.

In addition, well-designed and well-implemented SP interventions fostered by government actions contribute to solidarity, social cohesion, and social stability of a country.

Public interventions for more effective risk management can be:

- indirect (such as fostering the capacities of households to reduce the variability of income, improving saving capacities and risk-sharing, or facilitating the operations of market institutions such as banks, insurance companies and pension funds) or
- direct (such as providing transfers, subsidizing assets or goods, implementing public works programs, or mandating old-age income insurance).

While income risk is considered as individual, the measures to manage the risk are largely co-operative or social. Measures can be provided by the public or private sector, can be either formal or informal, and can be ex-ante (prevention and mitigation) or ex-post (coping) interventions.

C. How does thinking about SP as Social Risk Management help improve our work?

Currently, social protection is often defined as a collection of measures that includes: (1) social assistance, (2) social investment and development funds, (3) labor market interventions, and (4) pensions and other insurance-type programs. The overall concept unifying these areas deals with improving or protecting human capital.² Within each of the areas that Social Protection covers, there are, generally, a well-developed theory and operational practice. However, all too often we end up operating within the four cylinders and not looking at cross-cutting issues or we do not analyze the social protection system as a whole.

There are several advantages to using social risk management as the analytical framework for social protection, including:

- The concept is universal (i.e., time-space-independent) in that it brings a series of different interventions under one framework which can be applied both to all

² The link with human capital explains the placement of social protection organizationally within the human development network of the World Bank. As discussed later in the paper, social risk management requires a broad view of assets, and improving and/or protecting human capital is linked to the improvement and/or protection of other types of household' capital.

countries and over time. The appropriate mix between public/private, formal/informal, and ex-ante/ex-post arrangements differs among countries due to types of income shocks, level of economic and institutional development, culture and traditions. This precludes blueprints for countries, but also avoids seeing each country as specific case from which few lessons can be drawn.

- It also provides a unifying framework to assess the economic development effects of risk management arrangements. While some informal risk-sharing arrangements are rational from the individual or household point of view, they may impede economic development. While some formal and public arrangements work in their risk reducing capacity, they may hinder economic growth.
- The concept is institution-oriented, stressing the importance of functioning informal/formal, private/public institutions and, hence, institution-building to manage income risk optimally. It covers the gamut of institutions from the family (and the need of appropriate rules to prevent child labor supply and spousal abuse) to community support networks, public employment agencies, and private pension funds (and the appropriate regulatory and supervisory framework).
- It forces the discussion of appropriate interventions to begin at the individual and household level. This means that all interventions (direct public provision, public financing, regulations of the market etc.) should be judged by how they help individuals and households to better manage risk.

III. Key Issues of Social Risk Management

A. Why are we concerned with social risk management?

There are four main reasons why the World Bank is concerned with social risk management. First, the fight against poverty is the central mission of the World Bank, and a better understanding can be achieved and improved instruments developed if poverty is gauged in terms of vulnerability, that is, the increased probability of the lower income strata to become or to remain poor. Second, improved consumption smoothing due to better arrangements to manage income risk for all does not only increase individual and societal welfare, but also improves the welfare distribution in society as well. Third, improved equity is a major societal concern with its importance increasing with the number and depth of income shocks. And last, the form of risk management has an important bearing on economic development – some may hinder it, some may support it.

Vulnerability (within a poverty eradication concept) can be defined as the risk of economic units (such as individuals, households, and communities) to fall below the poverty line (i.e., having insufficient consumption and access to basic services) or, for those already below the poverty line, to remain in or to fall further into poverty. Anti-vulnerability policies are designed to prevent this from happening – ex-ante – and, as a result, to reduce the cost of ex-post poverty alleviation measures once individuals are

below the poverty line. Traditional anti-poverty policy is only concerned with bringing individuals up to the poverty line or at least reducing the depth of poverty (Lipton and Ravallion, 1995). Enhancing the static anti-poverty concept with the dynamic vulnerability concept through risk management measures should prove to be welfare enhancing. It will also build concern for the social and economic processes that drive movements around and below the poverty line. This, in turn, will provide focus on the development (dynamic aspects) of poverty eradication and the social context in which vulnerability reduction must take place (including highlighting the importance of social exclusion and marginalization).

Special cases are the individuals at the bottom of the income distribution. These people are so close to a “survival line” that they become extremely risk adverse, and exhibit other non-linearities in behavior and outcome (Ravallion, 1997). In our understanding, these people are the most vulnerable. For individuals higher up in the income distribution, small shocks (i.e., loss of income) may have the same probability of occurring as for those in the lower strata. The severity of the effect, however, will be lower because they can rely on accumulated assets while, for the people close to a survival line, all shocks are catastrophic and endanger even the most basic consumption (Jalan and Ravallion, 1998). Even though this is a special case, the basic conceptual framework still applies. The goal is to help these people better manage their risks – they just have an extreme form of risk and almost no capacity to manage risk by themselves. The intervention most often used is a direct transfer (in-kind or in-cash, by the state or community members) or an asset reallocation. This lifts the household far enough above the “survival line” to allow them to take more risk and engage in higher return activities.

Consumption smoothing and welfare distribution: Economic considerations and empirical evidence suggest that economic units have a preference for smooth consumption, spreading the consumptive use of expected income over a long period, even a lifetime (Alderman and Paxson, 1992; Besley, 1995; Deaton, 1997; Gerowitz, 1988). Because income realization is mostly stochastic and, during periods of negative shocks, income can be very low or even negative, this requires appropriate risk management instruments, such as saving and dis-saving possibilities in order to achieve a welfare-enhancing smooth consumption path. Yet, societal welfare is not only increased because the welfare of all individuals rises.

If society values a more equal welfare distribution across individuals, better risk management can enhance the welfare distribution and societal welfare without actually re-distributing income among individuals. Under the likely scenario that the lower income strata is more constrained with consumption smoothing capacities, enhanced public support for risk management arrangements lifts the constraints on the welfare level of this income segment to a larger extent, leading to a more equal distribution of individual welfare.³

³ Simulations suggest that this effect of risk management dominates the income re-distributive effect for a large set of parameters. See, Holzmann (1990).

Improved Equity is a main objective of SRM. The importance of direct public interventions for equity reasons increases once the concept of shocks is taken into consideration. The discussion of equity is traditionally gauged in two polar concepts: equity of opportunity and equity of outcome. While libertarians support the former, more leftist positions support the latter and consider the first insufficient. The concept of equity of opportunity has much appeal if resulting differences in income distribution are due to differences in individual efforts only, but it falters if main shocks threatening the survival of individuals are taken into account, strengthening the demand for ex-post corrections. The concept of equity of outcome has a lot of appeal on moral grounds, but it falters once changes in individual behavior are accounted for. As a consequence, improving equity treads a fine line between the minimum concept of furthering equal opportunity and the maximum concept of attempting equal outcome.

Economic Development: The instruments of social risk management are not neutral in economic development (Ahmad, Dreze, and Sen, 1991). Sending children to work as a measure to cope with income loss by the household is detrimental to their future income chances and the growth of the economy. Providing overly generous public pension benefits financed by labor taxes is likely to distort individual labor supply and saving decisions with static and dynamic efficiency losses. Risk management instruments may also foster economic development. A functioning family is, perhaps, the best instrument to reduce and mitigate individual income risk. Appropriately regulated and supervised funded pension provisions may contribute to financial market development and economic growth. Hence, risk management arrangements need to be carefully evaluated, changed or re-designed in order to maximize their contribution to the development of our client countries.

B. How to conceptualize social risk management?

We will suggest a typology for types of risk, strategies, instruments and institutions involved in risk management. This section briefly introduces the typology while the following sections (C through F) goes into more detail, explaining what we mean by the different definitions. The basic typology breaks down into four main categories

I. The type of income risk incurred, with three main distinctions:

- Catastrophic vs. non-catastrophic shocks
- Idiosyncratic vs. covariant shocks
- Single vs. repeated shocks

II. The type of strategies to address these income shocks with three main distinctions and subcategories:

- Risk reduction strategies (introduced ex-ante in order to increase the level of expected income and/or reduce the variance) such as active labor market policies.
- Risk mitigating strategies (introduced ex-ante in order to reduce the income variance with occasional costs for the expected income) in the form of:
 - Portfolio diversification (multiple assets with different risk characteristics)
 - Insurance (pooled coverage through payment of insurance premium)

- Hedging (risk exchange)
- Risk-coping strategies (introduced ex-post, i.e., once the risk has occurred) such as dis-saving/borrowing, charity, means-tested transfers and public works.

III. The type of instruments by the formality of arrangements, with three main distinctions:

- Informal/personal arrangements (such as marriage, mutual community support, and real assets such as cattle, estate and gold)
- Formal/market based arrangements (such as financial assets and insurance contracts)
- Formal/publicly mandated or provided arrangements (such as rules and regulations, social insurance, transfers, and public works)

IV. The type of institutions/actors in social risk management:

- Individuals/households
- Communities
- NGOs
- Market institutions (such as banks and insurance companies)
- Government

C. What are the risks considered? – a typology of risks

Income risks have many forms. They may affect individuals/households as a result of sickness, unemployment or bad harvest, or they may hit a whole community or even country as a result of epidemics, natural disaster, environmental problems or inflation. For a better understanding of the possible policy responses and applicable instruments, there are three important categories that aid in the classification of the main circumstances with which individuals/households must cope (Murdoch 1997).

Catastrophic vs. non-catastrophic shocks: In the life of a household, some events occur with *low frequency, but have severe income effects* – like old-age, death in the family, and disabling accidents or illnesses, permanent unemployment, and the technological redundancy of skills. These *catastrophic events* can hit households hard and may require a continuing flow of transfers to the affected household if it cannot acquire sufficient assets.

At the other end of the scale are *high frequency* events with *non-severe income effects* – like transient illness, crop loss, and temporary unemployment. Protection against these *non-catastrophic events* need not require long-term net transfers to the afflicted household. If appropriate mechanisms are available, households may use savings, loans, or reciprocal gifts with no net transfers from others over time.

Idiosyncratic shocks vs. covariant shocks: The second important distinction is whether or not only some households in a community suffer losses (*idiosyncratic shocks* like non-communicative illness or frictional unemployment) or whether all are hit at the same time (*covariant shocks* like drought, inflation or financial crisis). Many more mechanisms are

available for coping with idiosyncratic shocks than covariant shocks. The latter can be particularly devastating, leaving households with nowhere in the community to turn for relief. It should be remembered, however, that, for poor and isolated households, even idiosyncratic shocks might be difficult to cope with.

Single vs. Repeated shocks: A third distinction concerns shocks following one another – like drought followed by sickness and death. The recurring nature is also referred to as the degree of *autocorrelation* and highly autocorrelated events are typically difficult to handle through informal means.

D. What are the main strategies to address income risk? – a typology of strategies

Background: In a world with complete information, all of the shocks above could potentially be addressed with market-based solutions. Each risk would be known, have a price, and able-bodied individuals could fully insure themselves against them. All non-able-bodied persons (the deserving) would rely on public or private transfers provided for altruistic or other reasons. Yet, complete information is only a theoretical benchmark while asymmetric information in the real world gives rise to:

- transaction costs (and the non-existence of formal inter-temporal market institutions in many developing countries); and
- moral hazard, adverse selection, and insufficient property rights (and the existence of publicly supported and/or mandated provisions).
- As a further implication of asymmetric information, the risk distribution is not necessarily exogenous, but can be influenced by government measures. Insurance, even if it exists, is not necessarily the best ex-ante strategy compared to pre-saving, for example. And, in face of catastrophic/covariant/repeated shocks, there is a need for ex-post interventions.

In an imperfect world, there are many strategies to help households better manage income risks (Alderman and Paxson, 1992). These can be grouped in three broad categories⁴:

- **Prevention** strategies - to **reduce the occurrence of the risk** giving rise to income loss. They are introduced ex-ante in order to increase the level of expected income and to reduce the income variance.
- **Mitigation** strategies - to **mollify the risks** through improvement or provision of instruments which reduce the income variance ex-ante with occasional costs to the expected income.

⁴ For a different taxonomy of risk addressing strategies, see Townsend (1994). The proposed broad differentiation between ex-ante and ex-post measures, however, falls short of distinguishing between measures which prevent or reduce the risk to occur, and those which attempt to mitigate the risk for exogenously given risk distributions.

Types of capital and social risk management

For social risk management the definition of assets needs to be very broad. It would still include physical capital (land, buildings, and livestock), financial and human capital, but should also include social capital (belonging to groups with trust and high levels of cohesion) and the family structure itself (Davies, 19988; Ellis, 1998; Moser, 1998). While our theoretical constructs still have a long way to go in just coming to grips with an operational definition of social capital and an asset-like application of family structure, practical experience and statistical evidence suggests their importance in an asset management framework.

For instance in poor households in many parts of the world, preference is given to expenditures that invest in social capital over investments in human capital. E.g., the household prioritizes gift giving and costs associated with rituals over paying school fees. The giving of gifts and participation in rituals, is a form of membership fee to belong to a certain social group, i.e., an investment in social capital. Much of the literature on women, focus on the role of investing in family structure. E.g., women give up a job with a higher return for the "protection of the family."

Other examples indicate that the level social capital (measured via a trust index or a participation index) is positively related with GDP per capita and has a positive impact on economic growth. Hence, appropriate investment in "social capital" is a means to improve income conditions and reduce poverty, but the ways need still to be explored.

- **Coping strategies** - to **relieve the impact** of the shock; to improve instruments or provide transfers and other income support measures once the negative income shock has occurred.

(i) Strategies to prevent or reduce the occurrence of income risks by all economic actors, but mostly by governments, have a very broad range that surpasses the traditional scope of social protection. These strategies are comprised of sound economic policy, public health policy, environmental policy, dam construction, and many more areas of public intervention.

Preventive social risk management is typically linked with measures to reduce the risk for income generation, notably for labor. It is concerned with labor standards because occupational health risks impede future labor income and abusive child labor impairs health, education, and the emotional stability of children and their income chances as adults. It is concerned with vocational education and technical training because lower-skilled workers are more vulnerable to income risk and a well-trained labor force can better cope with macroeconomic and structural shocks. It is also concerned with the (mal-) functioning of the labor market, resulting from bad labor market regulations, wage setting agreements or overly high minimum wages which lead to labor market imbalances and the resulting income loss due to unemployment. But pro-active policies are also applied once the reduction in ability to obtain gainful employment has occurred, such as for the disabled, where policies are designed and implemented to enhance their earning chances, reduce their vulnerability and dependence on private and public transfers.

(ii) Strategies to mitigate ex-ante income risks can take various forms including assisting with portfolio diversification, insurance, and hedging. The objective of these actions is to

reduce the variability of income if a shock were to occur. While these actions can happen informally (through personal contracts and networks) or formally (through anonymous market relations), the government can improve the efficiency or equity of existing instruments or provide or mandate the provision of instruments. Again, many of these actions transcend traditional social protection policies. For example, providing the information on field and crop diversification or weather patterns will help reduce harvest and income risk.

A central instrument to reduce the variability of income consists of relying on various assets from which returns are not perfectly correlated, i.e., portfolio diversification (Ellis, 1998). This requires the acquisition and management of different assets such as physical capital, financial capital and human capital in their different forms. For example, if individuals can only invest in human capital, they can still diversify in different occupations, but perhaps at the detriment of the average return. If individuals can only invest in physical capital and cannot diversify, they may choose a lower return with a less risky technology. If women cannot own or inherit land and have no access to safe financial instruments, they may acquire gold and jewels. Government policy that improves the access to different assets not only allows a better risk mitigation, but may allow for high rates of return as well.

The second and perhaps most important form of risk mitigation comes in the form of informal and formal insurance. It is easy to state the characteristics of formal or market based insurance – the payment of a risk-based insurance premium gives rise to future state-contingent payments. Informal insurance arrangements are a bit trickier to describe in that they come in different and often disguised forms because one “institution” serves insurance and non-insurance type functions (such as the family and the community). This mix and the basis of informal insurance – trust as a result of repeated interactions – renders the involvement of government to strengthen the insurance function hazardous. Furthermore, some economists argue that mutual insurance is alien to traditional agrarian societies and, while those informal mechanisms provide insurance, they are guided more by a principle of balanced reciprocity⁵.

While hedging has an increasing importance for financial markets (e.g., forward exchange rate contracts) and is based on risk exchange or payment of a risk premium to somebody for taking over the risk, these arrangements do not appear to work in an income-related environment and formal provisions. The effects of asymmetrical information are too strong. However, elements can be found in informal/personal arrangements. For example, various family arrangements or some labor contracts are more germane to hedging than insurance.

⁵ Balanced reciprocity means that for any “gift” there is a strong assumption that at some, as yet unknown, time in the future there will be a counter gift. Hence informal insurance arrangements may be similar to a loan where the repayment loan is state contingent (e.g. see Plateau 1996, Ligon et al. 1997). Evidence for the latter is provided by Udry (1990; 1994) for Nigeria. On average a borrower with good realization repays 20.4% more than he has borrowed while a borrower with bad realization repays 0.6% less than he borrowed. Moreover, repayment are contingent on the lender’s realization. A lender with a good realization receives on average 5% less than he lent, but a lender with a bad realization receives 11.8% more than he lent.

(iii) Coping - to alleviate the impact of the shock once it has occurred. The main forms of coping consist of individual saving/dis-saving – borrowing/repayment or the reliance on non-requitable public or private transfers. Despite these formal and informal instruments, the government has an important role in coping with income variability once the risk/loss has occurred. Individual households may not have saved enough to cope with multiple or longer lasting shocks, running out of financial resources to finance their consumption. Households may have accumulated important assets for old age, but are faced with the uncertainty of length of life span. De-cumulating the assets over the uncertain remaining life span may leave them with too little consumption at high age or too much (unintended) bequests at early death if the assets cannot be converted into a (fair) annuity stream. Finally, individuals may have been poor for their entire lifetime with no possibility to accumulate assets at all, being rendered destitute by the smallest income loss.

Dis-saving in human capital

An extreme form of dis-saving is in human capital. There are many examples from Africa and other low-income countries (e.g., World Bank (94)) of how people when faced with a shock cut back on the number and size of meals. I.E., a direct dis-saving in human capital – because this is often the only asset that they possess. Unfortunately there is no way to recuperate this loss, if the lack of meals affect children at certain ages. This is another example of how a family risk management strategy is good in the short run, but is detrimental over a longer run.

E. The type of instruments by the formality of arrangements – a typology of instruments

The level of formality can distinguish the instruments/arrangements used under each strategy. Three distinctions are proposed:

- Informal/personal arrangements (such as marriage, mutual community support, and real assets such as cattle, estate and gold);
- Formal/market based arrangements (such as financial assets and insurance contracts);
- Formal/publicly mandated or provided arrangements (such as rules and regulations, social insurance, transfers, and public works).

(i) Informal/personal arrangements: With the lack of market institutions and public provisions, the response by *individual households* is self-protection through informal/personal arrangements. This sidesteps most information and coordination problems, but may be limited in its effectiveness. Examples include: the buying and selling of real assets; informal borrowing and lending; crop and field diversification; the use of safer production technologies (such as growing less risky crops); and the storing of goods for future consumption. Lacking formal (anonymous) insurance markets households may also engage in personalized insurance, i.e., *informal risk sharing*. They build on direct information (which avoids moral hazard and adverse selection) and relationships developed over years or generations (trust). Examples include: marriage and the extended family (and the implicit exchange provisions); remittances between friends and neighbors; investing in social capital; engaging in share tenancy; credit

contracts with state-contingent repayment; and the commitment to long-term contracts that guarantee a steady flow of income (tied labor).

A main advantage of informal insurance arrangements is the close interpersonal relationship and, in view of the good information base, the virtual absence of moral hazard and adverse selection. This comparative informational advantage of private agents with local knowledge speaks in favor of private arrangements strengthened by government actions. On the other hand, many elements of such arrangements may appear at odds with familial values such as the strong position of the (male) household head to ensure contract compliance or the forced marriage of (female) members to distant location to ensure risk diversification.

(ii) Formal/market based arrangements: With the existence of market-based institutions such as money, banks, and insurance companies for intertemporal exchange, individual households will also use these instruments for managing income risks. But, in view of their limitations due to asymmetric information, their use will be restricted. Their use, however, will rise with financial market development.

Financial saving as well as the accumulation of other assets that can be sold at fair market prices is perhaps the most important asset management instruments used to address income variability. Pre-saving is inferior to full and fair insurance in as much as it leads to discontinuities in the consumption path (if the income risk no longer exists and the savings is now spent) or to lower lifetime consumption and lifetime utility (if the saving is involuntarily passed on as inheritance). Yet, if no fair insurance arrangements exist, pre-saving is powerful instrument to cope with high frequency and non-autocorrelated income shocks for the poor. This empirical evidence suggests that the establishment of a sound banking system and non-inflationary policy is an important device to cope with consumption vulnerability.

Similar considerations apply to the capacities of individuals to borrow during periods of income loss. Assets may exist, but prices may be temporarily low, transaction costs high or the individual household may not have had the time to accumulate. Borrowing is also important to buy for inputs during period of low cash income and to secure future income streams. Because formal market institutions are reluctant to lend to households without secured earnings, micro-financing is an important instrument of social risk management. In the case of barriers to trade such as private (asymmetric) information, limited communication, and limited legal systems, efficient credit delivery systems of financial institutions may require explicit or implicit insurance provisions in loan contracts. And, in doing so, makes (public) interventions in favor of women, poor, and remote areas a redistributive instrument of social policy.

The early acquisition of life savings accounts and annuity contracts allows the handling of catastrophic shocks from disability and old age. Similarly, buying health, property, and crop insurance and saving and borrowing facilities aid in the management of high frequency downturns. Yet, market-based arrangements may not be able to cope with the consequences of asymmetric information (moral hazard and adverse selection) and

provide unemployment insurance or pension annuities only at grossly actuarially unfair prices.

(iii) Formal/publicly mandated or provided arrangements: To overcome the effects of adverse selection, governments can mandate insurance of all unemployed (pooling), pursue meritorious goals (income redistributing and coping with myopia) or safeguard the government against strategic behavior of individuals as a result of minimum benefits. It can mandate or provide insurance for old age, disability, survivorship, accident, and sickness. In addition, the government has a whole array of instruments to cope with the consumption effect of lost income. The choice will not only depend on distributive concerns, but also on the available fiscal resources and administrative capacities, and the type of shock. It will also depend on efficiency concerns because the form of provision will impact individual labor supply and saving decisions that the government can only monitor insufficiently. Governments may provide public works at below market wage. This self-targeting instrument can substitute for, or complement unemployment benefits. Governments can provide social assistance benefits in-cash or kind in a targeted manner (i.e., means tested) for all below a determined poverty line. Or governments can provide a minimum income in a universal manner to the total population (demogrants) or a subgroup (such as the elderly).

Table 1 fills the intersection of main strategies and arrangements with typical examples.

F. Institutional roles - who does what in social risk management

Because the issue of social risk management emerges as a result of private (asymmetric) information, the role of the actors/institutions can be seen in their capacity to best cope with information asymmetry. But because this asymmetry also gives rise to imperfect market institutions (market failure) as well as non-benevolent government behavior (policy failures), the relative roles have to be viewed in perspective.

Because individuals/households have all the private information, most risk management can take place on the household level. Risk-mitigating strategies through the acquisition of different assets and risk-coping strategies through accumulation and decumulation decisions optimize the consumption path to a large extent. But, in view of insufficient market institutions (such as access to credit), not all decisions are socially desirable even though they may be perfectly rational for the individual or the household. For instance, taking girls out of school to help fetch water during a drought may be rational in view of lacking access to credit, but the loss to society is much greater than the short term individual gain. SP interventions need to be designed so they work with and build on such strategies. Instead of lowering the cost of schooling, it may be more appropriate from a societal point of view to invest in a better water supply closer to the village or to provide better access to credit.

Next to households, communities have a large stock of private information. Hence, lacking the appropriate market institutions, communities have developed various informal mechanism of risk-sharing in developing countries. Examples include 'susu' schemes in West Africa; mutual support arrangements reinforced through celebrations and rituals;

Table 1: Strategies and Arrangements of Social Risk Management

Arrangement Strategies	Informal/Personal	Formal/ Financial market-based	Formal/Publicly-mandated/Provided
Risk reduction			
	Less risky production Migration		Labor standards VET Labor market policies Disability policies
Risk mitigation			
Portfolio	Multiple jobs Investment in human, physical and real assets	Investment in multiple financial assets	Multi-pillar pension systems Social Investment Funds Asset transfers
Insurance	Marriage/family Community arrangements Share tenancy Tied labor	Old-age annuities Disability/Accident	Mandated/provided insurance for unemployment, old age, disability, survivorship, sickness, etc.
Hedging	Extended family Labor contracts		
Risk coping			
	Selling of real assets Borrowing from neighbors Intra-community transfers/charity Sending children to work Dis-saving in human capital	Selling of financial assets Borrowing from banks	Transfers/Social assistance Subsidies Public works

and burial societies in Andean countries. But while those mechanisms may provide informal insurance, some of them may be socially undesirable because they perpetuate dependency structures or impede on economic development.

NGOs may not have as much private information as tightly-knit communities, but their local and informal character allows them to monitor individual behavior better than full-blown market institutions. This explains the existence and importance of NGO-sponsored savings and micro-credit schemes in many countries. The latter may also be provided by Social Investment Funds which have the rationale of efficiently circumventing (inefficient) public administration and being demand-driven and, consequently, also able to cope with information asymmetry.

Market institutions such as banks and insurance companies have to rely on public information and, as a result, cope with issues of moral hazard and adverse selection. On the other hand, if well-regulated and supervised, the shareholder value concept leads them to transparency and high efficiency providing individuals nationwide with the broad variety of risk management instruments. Market institutions in a competitive environment, however, can also be efficient instruments to deliver public services financed by the public sector (such as job placement, social assistance payments, etc.). The main challenge in coping with this new principal-agent problem between the public and private sector institutions is to draft contracts that circumvent the private information problem as much as possible.

Finally, the government has many important roles in the area of social risk management. The most important of these roles are: (i) facilitating the set-up of financial market institutions to this end; (ii) establishing the regulatory and supervisory framework, including a transparency requirement and consumer information; (iii) providing risk management instruments where the private sector fails (unemployment insurance) or individuals lack the information for self-provisions (myopia); (iv) providing social safety nets and large scale transfers in the case of main or recurrent shocks; and (v) providing income distribution if the market outcome is considered unacceptable from a societal welfare point of view.

IV. Boundaries and Balances of Social Protection as Social Risk Management

Defining Social Protection as SRM raises many key questions, including: (A) the delineation with other sectors; (B) the role and scope of distributive policies; (C) the impact of risk management, or its absence, on static and dynamic efficiency, i.e., economic development and growth; and (D) the political sustainability of the proposed best technical solution.

A. Boundaries with other sectors

There are many overlaps with what falls under SP and what is covered by other sectors, particularly in the area of risk prevention and reduction. Any economic and other governmental policy that enhances growth and reduces income variability also supports the objectives of SP. This means that there is a need for delineation at the analytical and institutional levels. This does not mean that the SP strategy for a country should not begin with raising the awareness of a sound and credible economic policy as being crucial for a well-functioning SRM system.

(i) Building greater awareness about the importance of broad policies to create a less risky environment for households and communities is primordial. There is still an insufficient understanding among academics in the developed world and policy makers in client countries of sound macroeconomic policy, sound financial markets, enforcement of property rights, respect of basic labor rights, or growth-oriented policies as the first and best ingredients to reduce the consumption effects of variable income. If those policies

are in place, households are much less vulnerable and can achieve most of their consumption smoothing with personal instruments. This calls for measures to build greater awareness within client countries and among donors.

(ii) There may be a specific role in SP alerting other sectors that preventive measures are required and are cost efficient in present value calculation. Recent examples are the effects of “El Niño” and the welfare implications of this catastrophic shock for the concerned worldwide population. Ex post measures of the government to cope with the income effects may prove more expensive in present value terms than ex ante measures in the area of public infrastructure (Vos and de Labadista 1998).

(iii) Among the specific measures to reduce the income risk ex-ante, there are many measures that potentially transcend other sectors. The suggested analytical delineation is based on labor market relations with SP taking care of measures which reduce the risk of wage income variability, leaving the risk reduction policies for other incomes (from physical and financial capital) to other sectors. While better functioning labor markets contribute to enhanced human capital, there are other sectors that contribute to its protection and improvement (such as education and health).

(iv) The common goal of improving human capital or reducing income risks in agriculture where income accrues to households through joint input of labor, land and capital creates areas of joint ownership of cross-sector activities. Examples include: vocational education and technical training, child labor, disability, and micro-finance. In these areas of joint ownership, an institutional delineation is suggested with the lead taken by one sector, joint work or full integration of work depending on the budgetary, personal, and institutional setting.

B. Scope, form, and limits of re-distributive activities

On the surface, SRM does little to provide a role for the re-distributive activities traditionally seen as a core element of SP (or the welfare state, see Barr, 1998). This impression may result from the fact that, in a SRM setting, there is a more than interpersonal redistribution to enhance the welfare distribution of households, cohorts, and generations. Improved inter-temporal distribution of income allows better consumption smoothing and is welfare enhancing without a re-distribution of income among individuals or cohorts taking place. For example, a re-designed pension system in view of population aging can contribute to inter-generation equality without an explicit redistribution between cohorts. Still, four issues deserve special attention: (i) resource flows from the “better-off” towards the most vulnerable and lifetime poor; (ii) non-social income; (iii) issues of social inclusion/solidarity/cohesion/stability; and (iv) generation/regional/inter-country inequality needing to be addressed.

(i) The mission of poverty reduction dictates that waiting for economic growth to lift everybody above the poverty line is insufficient. At least a minimal amount of resources are needed to help cope with the most drastic forms of poverty. This traditional anti-poverty concern is the reason for social safety net/social assistance programs worldwide. The concept of vulnerability supports these poverty concerns, but puts them in a dynamic

framework in which the risk of becoming poor is also accounted for, and risk management mechanisms are assessed in their capacity to minimize this probability in distributive effectiveness and dynamic efficiency terms. Within the traditional poverty view, the level of poverty and available budgetary resources of a country as well as its preferences determine the scope of such interventions. For example, if 60 percent of the population live below \$2 per day, the budgetary resources may not be available to address deep poverty. The form of intervention is, in part, determined by efficiency considerations, i.e., supporting the poor while minimizing distortionary effects and poverty traps.

(ii) The concept of SRM is largely, but not exclusively focused on income variability with income very broadly defined and encompassing market income, imputed income, income in-kind, etc. This broad definition of income takes care of concerns about social services that cannot readily be bought on the market. These services require public intervention through public provision, financing or regulation to force private provisions (such as rules for children to take care of their elderly parents). Hence, SRM is not restricted to the monetary aspects of income/consumption support for the vulnerable poor of the society, but merely emphasizes the income equivalent for analytical reasons.

(iii) There are, of course, other aspects of SP that cannot readily be cast into income equivalents. The most important of these are concerns for social exclusion/inclusion,

The three main political paradigms of social exclusion

The first paradigm is usually coined the solidarity paradigm with exclusion defined as "the rupture of a social bond between the individual and the society, referred to as social solidarity." A society is characterized by cultural boundaries, by which the poor, ethnic minorities or unemployed end up as deviant outsiders. The source of integration of these groups would be "moral integration." The state is obliged to aid in the insertion of the excluded.

The second paradigm, represented by Anglo American liberalism, draws exclusion as a consequence of specialization, which refers to social differentiation, economic division of labor and a separation of life spheres. The mere fact that individuals differ does not yet raise concern. It is the discrimination aspect that is seen as a problem. Separation of spheres would not lead to hierarchically ordered social categories, if individuals were free to move across boundaries. In a liberal view of society the contractual exchange of individual rights is a basis of welfare. If this exchange, if mobility between spheres is impossible, then division of labor may end up in social exclusion.

The third paradigm sees exclusion as a consequence of the formation of group monopoly. "Powerful groups, often with distinctive cultural identities and institutions restrict the access of outsiders to valued resources through a process of social closure". A good example is labor market segmentation that draws boundaries of exclusion between and within firms. While in the specialization paradigm the source of integration is exchange, the monopoly paradigm relies on citizens' rights as a means to change the status of exclusion.

Source: Silver (1995) and Badelt (1998).

social solidarity, social cohesion, and social stability. In order to address these qualitative objectives of social policy, a clear definition is required for determining the appropriate instruments. With regard to social exclusion, various definitions exist (see box) with the

solidarity paradigm the most used and, likely, the most useful one. Largely independent of a precise definition, all dimensions of these qualitative social policy objectives – social inclusion, solidarity, cohesion, and stability – can be defined as positive externalities resulting from a well designed and implemented SRM in view of asymmetric information. For example, a well designed income support system for unemployed will not only enhance individual welfare through lower vulnerability and better consumption smoothing, but will also carry toward the qualitative objectives such as social stability. Furthermore, effective social risk management strategies will have to take account of the gender dimension (see box).

SRM and Gender

Effective SRM strategies need to include an understanding of how gender relations affect the implementation and impact of different policies or programs. It is essential in developing SRM approaches that a clear recognition of the different roles of men and women shape how policies are designed and carried out. The structure of gender roles and expectations help shape the capacity of women, households and communities to absorb and adjust to economic shocks.

Policies of Social Risk Management thus require a gender lens that incorporates the needs of individuals into a wider set of social and economic relations. For example, in terms of gender perspectives, these can include such factors as labor markets, credit markets, social conventions, dynamics of local food availability, or women's participation in key tradable' sectors.

Development of SRM strategies can include an analysis of the demands on women in the household or family life. The design of SRM programs as related to potential economic shocks can incorporate past experiences that guide formulating gender aspects of prevention and coping systems.

(iv) Last but not least, SP raises the issue of income redistribution between generations, regions or nations. Distributive issues between generations emerge when public transfer programs increase current period consumption at the cost of capital stock formation and, thus, at the detriment of the incomes of future generations or when an aging population squeezes the consumption possibilities of the active generation. Important regional income differences in a country, federation or supra-national body (such as the EU) raise the issue to what extent an income redistribution should take place to support income convergence (through transfers enhancing capital accumulation) or equal social and economic conditions (through transfers increasing the consumption possibility), and the conditions under which these transfers are effective (Hervé and Holzmann, 1998). Finally, the large and often rising income differences between the rich (northern) and the poor (southern) countries give rise to claims of needed redistribution in a globalized world (Deacon et al., 1997). Those issues, while clearly important, transcend SP and touch on many questions of macro, fiscal, and international economics as well as international welfare economics for which the analytical basis, economic effects, and best instruments are not yet fully established.

C. Economic development issues

SRM is not neutral to economic development: it may support it through the choice of more productive production technologies, and the way gender is dealt with (see box) but

it may also hamper it through the elimination of risk and changes in individual behavior. This renders the choice of risk management instruments an important tool for economic development and may give rise to a trade-off between short-term effectiveness and long-term dynamic efficiency.

(i) There are many arguments for the view that insufficient risk management instruments impede efficient decisions and economic growth. Because the poor are risk averse, the absence of adequate risk instruments makes them pay an even higher price and, hence, contributes to poverty. There are various ways in which this can occur. One way is via effects on production decisions. For example, outmoded agricultural technologies can persist because they are less risky and credit is scarce. Another channel is through portfolio behavior. By this argument, uninsured risk induces poor credit-constrained households to hold unproductive wealth. Lastly, one channel is through the investment in human capital. It is argued that lacking access to credits means poor families must pull their children out of school to provide labor in the face of an income shortfall (see box). Against this background (which has economic appeal and some supporting empirical evidence), it is suggested that the provision of adequate risk management instruments allows the choice of more efficient production technologies, portfolio selections or decisions for human capital formation.

SRM and Children

Children tend to be invisible in the shaping of policies on poverty reduction and risk management. Generally children are incorporated into the category of the "household", but this can obscure important distinctions in terms of age and gender. Attention to children in SRM initiatives should give attention where possible to the social fabric of the community rather than individualized interventions.

At times of economic shocks, parents and communities face hard decisions in regards to schooling, work and residence. What are adaptive strategies that can help children balance work and school? Boys tend to work more directly in income earning settings, while girls often respond by taking on more household responsibilities. Both take part in household enterprises depending upon the locale and economic needs.

SRM strategies can identify key indicators and areas of vulnerability in the lives of children, and thus shape prevention and coping programs. SRM approaches can provide support for the fabric of the local community in order to reduce the pressures on children to live on the street or accept harsh employment conditions. SRM can also identify programs with local organizations that can remove children from harmful or at risk settings, as the costs to children already at risk will increase in times of economic shock.

(ii) Full insurance against risks allows a choice on the efficiency frontier based on risk preferences. However, private and public insurance is characterized by asymmetric information leading to problems of moral hazard and adverse selection. As a result and as noted above, private insurance markets may not be established or may not be efficient. The public provision of insurance against income risk may improve the outcome for a wide range of risks, but may also reduce individual efforts (such as job search) or lead to taking too much risk. And may end up in a worse situation than without such protection.

It is often feared that the reduction in individual effort may be compounded by pervasive income distribution that is often part of public welfare systems. In addition, welfare state interventions may imply a redistribution paradox where more redistribution results in more inequality (Sinn, 1994). This calls for a careful analytic and empirical assessment of publicly provided and managed risk management instruments.

(iii) Starting with informal SRM instruments in less developed economies, one can also be confronted with a trade-off between distributive effectiveness versus dynamic efficiency. A wide variety of informal arrangements may be effective in providing risk mitigation for the covered group, but it may come at high costs for current and future income, particularly for the poor. On the other hand, many publicly provided alternatives appear costly in the short run because additional budgetary resources have to be raised and harmful distortions and disincentives are introduced. De-placing informal with public arrangements may imply long-term efficiency gains if, for example, repressive informal institutional structures and low-level production technologies are replaced.

D. Political sustainability issues

Discussions about the SP programs (or more generally about the welfare state) have long been seen in a simple trade-off between equity and efficiency once the social welfare function over individual income positions is defined. Yet, the experience with public interventions and attempted reforms has taught us that the best technical solution may not be politically sustainable. As a result, the original, first, best design is blurred or totally reversed, while changes to a potentially sustainable second best solution prove politically difficult or even impossible. This suggests that considerations of political economy have to be part of system design and reforms. And the simple trade-off has to be extended to a “menage-à-trois”: equity, efficiency, and political sustainability. At the level of policy design, three approaches are suggested:

(i) The deterioration in system design and implementation of public SP programs is the result of not only changing voter coalitions, but of personal interests by politicians and bureaucrats as well. One method of protecting the original design consists of an appropriate self-binding mechanism, enhanced transparency, and stricter accountability. Relatively successful examples of such an approach include the long-term fiscal projections under the US pension system, present value budgeting in New Zealand, and periodic evaluations of all existing programs and of proposed changes in many industrialized countries. While these recent changes often help, more needs to be done with respect to our client countries.

(ii) Once political sustainability becomes a criterion for program design, the resiliency toward political risk becomes an important element for program selection. The conjectured trade-off between equity, efficiency, and sustainability suggests that an explicit second best solution from an efficiency or equity point of view may be selected if they are considered more resilient to political risk. Examples include individual savings accounts to cope with income risk due to unemployment or health compared to unfunded and publicly managed provisions.

(ii) Reforming public programs of risk management such as pensions, unemployment or sickness benefits proves very difficult politically. Entrenched interests, acquired rights or a lack of credibility of the proposed alternatives are among the most common obstacles. While resistance to reform is not specific to SP programs, the problem is particularly prevalent and difficult to overcome. This suggests that, in order to be able to introduce new and better instruments of SRM, a better understanding of the political economy of reform is required.

V. How does this affect our View of Social Protection?

Applying the social risk management concept may change our view of social protection and the instruments needing improvement or invention. The change will evolve during the work on the SPSSP, and the development of country-specific, regional, and a global sector strategies. For this reason, no conclusions are here attempted. The following is a tentative list for which comments and suggestions are welcome:

- SRM provides an integrated view on informal, market-based and public risk management arrangements and:
 - Stresses the importance of all arrangements, and the shift in importance and structure with economic development;
 - Allows a common assessment of these arrangements against the benchmark – reduction in vulnerability, improvement in consumption smoothing, enhancement in equity, and contribution to sustainable economic development;
 - Emphasizes that all types of arrangements - while attempting to contribute to risk management - can be detrimental to economic development.
- Moving from the static poverty to dynamic and risk-based vulnerability concept broadens the scope of traditional poverty reduction policies from reactive and transfer-type to pro-active measures.
- Heightens the importance of policy measure to strengthen informal arrangements, such as:
 - Family as pro-active, risk mitigating, and risk coping institution;
 - Communities and importance of social capital;
 - The role of NGOs in providing risk-mitigating and targeted risk-coping support.
- Fosters the importance of new and innovative formal arrangements, such as:
 - Multi-pillar pension systems;
 - Individual social accounts to handle multiple risks (unemployment, sickness disability, survivorship, old-age);
 - New delivery systems of health care.
- Offers legitimacy to many intervention as risk management mechanism, such as:
 - Micro-credit institutions;
 - Targeted credit arrangements to poor, women, and remote areas;

- Social Investment Funds with pro-active (e.g., income generation and education), risk mitigating (e.g., water supply) and risk coping features (e.g., public works).
- Puts the role of the government in perspective:
 - Governments have an important role for the establishing and functioning of informal and market-based arrangements;
 - Governments and public administration also have their own agenda, exposing such arrangements to political risk.

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Summary Findings

The *Social Protection Family of the World Bank* is scheduled to develop its Sector Strategy Paper (SSP) by the fall of 1999. This is an opportunity for the sector to take stock of its accomplishments and to develop the strategic thrust of the World Bank's future work in this area. This note serves as a conceptual background piece for this work, and is currently being used as background for the development of regional social protection (SP) strategy papers.

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