COMPARING UNEMPLOYMENT INSURANCE AND UNEMPLOYMENT ASSISTANCE*

Markets alone cannot provide adequate protection against the risk of unemployment. Private unemployment insurance (UI) fails because of informational problems: the so-called moral hazard (changes in behavior in the presence of insurance that are impossible or very costly to detect) and adverse selection problems (high-risk workers make insurance unattractive to average- and low-risk workers). Hence the mandate for social policy.

But social policy has to deal with the same problems that render markets inefficient. Mandatory participation mitigates the problem of adverse selection, but the moral hazard problems remain. In addition, the existence of a social protection program may give rise to inefficiencies of its own. Particularly with the rise of unemployment in European Union in the last two decades, inefficiencies created by UI, the traditional and most widely used public program of income support for the unemployed in developed economies, have become more widely discussed, and solutions and alternatives sought.

This note considers unemployment assistance (UA) as an alternative to UI. By targeting the benefits to those with the lowest incomes, UA provides the potential for savings. At the same time, UA obviously imposes more demanding administrative procedures and thus imposes other costs. Moreover, by paying benefits only to families which pass a means test, the program may introduce additional labor-market disincentives. We look into these issues in more detail below.1 We describe the two systems, analyze their generosity, targeting and efficiency, and consider the applicability of UA to developing and transition countries.

Description of the two systems

Unemployment insurance is the most common program of income support for the unemployed in developed countries. In the 1990s, UI programs were introduced by all transition countries and several developing countries as well. The use of UA is more restricted. Self-standing UA programs exist in only few countries, for example, in Australia, Hong Kong (China), and New Zealand (Vroman, 2002). In many other countries where UA is present, it exists in tandem with UI (“dual systems”); that is, UA is available for claimants who have exhausted UI or for those ineligible for UI at the onset of their unemployment.

Both UI and UA compensate workers for the loss of earnings due to unemployment. While payments under both programs are triggered by unemployment, the primary goal of UI is consumption smoothing, and the primary goal of UA is poverty reduction. This, probably the main difference between the two programs, is reflected in benefit eligibility requirements: under UI, eligibility is conditional on individual’s past contributions to the program; under UA, it is determined by an income or means test.

Table 1 compares the main features of UI and UA programs. Both programs make payments for partial as well as total unemployment. Payment for partial unemployment is more common with UA programs but some

---

* This note was prepared by Milan Vodopevic and edited by Tim Whitehead. It draws heavily on Vroman (2002), the background paper prepared on the topic of this note.

The World Bank Employment Policy Primer aims to provide a comprehensive, up-to-date resource on labor market policy issues. The series includes two products: short notes, such as this one, with concise summaries of best practice on various topics and longer papers with new research results or assessments of the literature and recent experience. Primer papers and notes are available on the labor markets website at <www.worldbank.org/labormarkets> or by contacting the Social Protection Advisory Service at (202) 458-5267 or by email at <socialprotection@worldbank.org>.
paid work is also permitted by UI while in receipt of benefits. Under UI, the reason for job separation is important — workers dismissed on disciplinary grounds are disqualified, and often the same is true for voluntary separations (though eligibility may be granted after a waiting period). Moreover, to be eligible for UI, the claimant must also have substantial previous work experience with paid UI contributions, as signaled by a required threshold level of previous earnings (USA), weeks worked (Germany) or hours worked (Canada). In contrast, UA can compensate those with little or no previous work experience and focuses eligibility determinations heavily on family income and assets. Both programs make yes-no decisions about initial eligibility and the level of the periodic payment, but only UI sets duration limits when the benefits start.

To continue in benefit status, claimants under both programs must be able to work and be available for work. Increasingly countries are requiring evidence of active work search as well. The latter requirement has various names, e.g., activation, reciprocal obligation or mutual obligation. While country practices regarding activation vary, merely waiting until a “suitable” job is offered is generally becoming less acceptable for maintaining continuing benefit eligibility (see below the example of Australia). Enforcing work search requirements, judging the suitability of job offers and monitoring job refusals are administrative tasks common to UI and UA. Both programs also monitor the receipt of other income that may reduce entitlements. In UI, the other income is typically linked to previous work, e.g., severance pay and pension benefits, and occasional current earnings. In contrast, all family incomes (and assets) are considered in the income

Table 1. Comparison of the main features of unemployment insurance and unemployment assistance

<table>
<thead>
<tr>
<th>Initial eligibility</th>
<th>Unemployment insurance</th>
<th>Unemployment assistance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Requirements on the claimant</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Total or substantial unemployment</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Substantial prior work experience</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Acceptable reason for separation</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Serve a waiting period</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Low family income (and assets)</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Administrative agency determinations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Entitlement, yes-no</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Level of periodic payment</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Continuing eligibility</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Requirements on the claimant</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Able to work</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Available to work</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Active work search</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Low family income (and assets)</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Administrative agency oversight</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Work search</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Suitable job offers</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Disqualifying and/or deductible labor income, e.g., occasional earnings, pensions</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Family income monitoring</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Determination of benefit level</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depending of previous earnings</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Flat/depending on current family income</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Maximum potential duration</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Funding</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contributions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>General taxes</td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>
(means) test for UA – an obviously demanding administrative task. If income monitoring is effective, changes in the spouse’s earnings, for example, will often alter the UA payment.

The determination of benefit level and duration differs across the two programs. Under UI, benefits are usually a proportion of average earnings over some stipulated period of the most recent employment spell, generally between 40 and 75 percent, and are limited in duration. Under UA, in contrast, benefits are typically a flat-rate (equal amount paid to all), but the level of benefits can vary according to family income, the presence or number of dependents, and the ages of children. In dual-system countries, UA benefits are typically lower that UI payments. Moreover, UA benefits are sometimes offered indefinitely (for example, in Australia) so long as the recipient satisfies the means test and remains unemployed.

There are also significant differences in the funding of the two programs. Employer and/or employee contributions assessed on wages typically finance UI programs (though the government may subsidize the program by paying its deficits). General tax revenues typically fund unemployment assistance.

Comparison of the generosity of the two systems

The distinguishing feature of UA is the screening of potential benefit recipients with an income/means test, instead of granting the benefit to all workers with sufficient employment histories and paid contributions as under UI. Does this targeting of benefits to the most “needy” produce savings?

Other things equal, the elimination of potential claimants by income/means testing is bound to produce savings. But the experience of Australia and New Zealand – two of the few countries that have a self-standing UA program – apparently contradicts this claim. Measured by the generosity index of unemployment benefits (see Box 1), the costs of both systems exceed the comparable average cost of UI systems in 12 OECD countries (see Figure 1). At the same time, the costs of unemployment benefits in the other two countries with the UA system, Estonia and Hong Kong, are much lower than the average costs of UI systems in OECD countries.

Let us explain this counterintuitive result using Australia as an example. First, the Australian system offers a high income-guarantee. The basic income guarantee is 25 percent of the average wage, which produces replacement rates typically in the 0.60-to-0.90 range – relatively high by international comparisons. Second, while excluding better-off unemployed workers from benefits, the system attracts other workers who are normally ineligible under the UI system: those without substantial prior work history, and low-paid employed workers (full-time workers with low wages constitute 20 percent of recipients). Moreover, because of the high income-guarantee, most of the unemployed are benefit claimants despite the income test. As result, after 1995 the number of recipients has exceeded the number of unemployed. (As in Australia, recipiency rates in New Zealand are very high while replacement rates are not especially high.)

Administrative costs under UA are also higher than those under UI. Additional costs under UA are associated with the costs of monitoring income/assets (initial assessments for new claims and monitoring for ongoing claims). These costs typically exceed the costs of initial eligibility determination under UI, which are incurred once.
per claim. The costs of monitoring availability for work and job search are similar in the two systems.

While UA systems in Australia and New Zealand fail to produce savings, those in Estonia and Hong Kong are much more frugal. Estonia’s index of generosity is among the lowest in the European transition economies, the result of a low recipiency rate and a low replacement rate (Vodopivec et al, 2003). Hong Kong also has a low recipiency rate, but its replacement rate is actually quite high (Vroman, 2002). The experience of these two countries shows that UA can be low cost programs.

To conclude, UA systems are not necessarily less expensive than UI systems. That is, means testing per se does not ensure that an unemployment benefit system is inexpensive – a country choosing UA may experience high, low, or intermediate costs of unemployment protection, depending on the choice of the system’s parameters - primarily, the income-threshold that triggers UA.

**Targeting**

While UA does not necessarily produce savings, the system is a progressive system, outperforming a UI system in the ability to redistribute income to the poor. This is not surprising at all, as the primary objective of UI is consumption smoothing and not income redistribution.

Both Australia and Estonia stand out as having more progressive unemployment-benefit systems than their comparison countries (no information was available for the two other countries with UA systems, Hong Kong and New Zealand). As shown by Forster (2000), in the 1990s unemployment benefit systems in OECD countries only mildly redistributed income from the rich to the poor: these systems were progressive in about half of the studied OECD countries (Australia, Austria, Belgium, Finland, Hungary, Ireland, and the United Kingdom), and neutral in the other half (Canada, Denmark, France, Netherlands, Norway, Sweden, and the United States). Interestingly, the most progressive system among the studied countries was the Australian one. Comparative data for 13 OECD countries show the overall share of UI/UA transfers going to the bottom three deciles ranged from 20.8 percent in Italy to Australia’s 58.0 percent with the second highest percentage being 53.5 percent in France. Conversely the top three deciles in Australia received 7.4 percent of transfers, the lowest percentage across the same 13 countries. The Estonian system also shared this high progressivity. Vodopivec et al (2003) report that, in Estonia in the mid-1990s, the bottom quintile in the income distribution received 31.1 percent and the highest quintile 13.6 percent of unemployment benefits, which was the highest and the lowest percentage, respectively, among the group of seven transition countries studied.

While the above results suggest that UA can effectively reach those whose income is below a stipulated income guarantee, there is one potential danger that may preclude the program from doing so. As argued by Atkinson (1995), income- or means-testing may suffer from problems with the program’s take-up. Experience in Western countries suggests that a third or more of potential claimants never receive the benefits: the reasons include information problems, administrative complexities, and stigmatization of recipients. Depending on prevailing cultural norms and habits, this may also be a serious problem in developing and transition countries.

**Efficiency**

There are numerous ways through which unemployment benefits may influence economic efficiency. By changing the opportunity cost of leisure and through a variety of other channels, unemployment benefits may affect unemployment, employment, and labor force participation, as well as job search intensity, post-unemployment wages, the labor supply of other family members, and the choice between entering regular and informal jobs. Unemployment benefits may also interact with adverse shocks and contribute to the persistence of unemployment. And by interfering with allocation decisions of

---

**Figure 1: Comparison of generosity of UI and UA, 1990s**

Notes: The columns depict the generosity index of unemployment benefits. For Australia, New Zealand, Hong Kong and Estonia, average for the 1990s (for Estonia, 1994-99). OECD average is obtained from data for Belgium, Denmark, France, Germany, Greece, Ireland, Netherlands, Portugal, Spain, Sweden, UK, and US, for 1992. Source: Vroman (2002).
economic agents, benefits may have a separate effect on output and growth of the economy – for example, by influencing enterprise restructuring and layoff decisions. On the positive side, unemployment benefits act as automatic stabilizers of the economy; they also provide additional means to the unemployed and may thus enable more effective job search.

Because of their similarities, UI and UA share efficiency effects, though the size of the effects may differ across the programs. For example, one can conjecture that UA – like UI – is prone to the moral-hazard problem, and that it may contribute to higher equilibrium unemployment (via increasing the bargaining power of trade unions) as well as to the persistence of unemployment (by creating more long-term unemployed). Moreover, both programs play the role of automatic stabilizers (for the discussion of efficiency effects of UI, see a Primer Note "Efficiency Effects of Unemployment Insurance").

Although no rigorous analysis of this topic has been done, it seems that disincentives associated with unemployment benefits may be as severe under UA as they are under UI. Two features of UA deserve particular attention: (1) that benefits are indefinite and contingent on the family income (and assets) of the unemployed individual, and (2) that eligibility is not necessarily contingent on previous work experience. These two features suggest that, in some cases, the severity of job search/acceptance disincentives may be even more pronounced under UA than UI. First, according to job search theory, the intensity of job search increases when benefits are about to expire, an effect which applies only to UI because under UA, the horizon is usually unlimited. Moreover, by requiring previous employment as an eligibility condition, UI creates stronger re-employment incentives in comparison to UA, which ignores previous employment status. Such is a theoretical prediction of Heer (2000), who shows that an increase of benefits has a strong disincentive effect on a worker's search effort under UA, but it has an ambiguous effect for some workers under UI: i.e., because they expect higher unemployment benefits if they become unemployed in the future, some workers increase their job-search effort under UI.

Second, payments of UA benefits to an unemployed family member may influence labor supply decisions of other family members. If one of the spouses is unemployed, the other may be less likely to work as the extra earnings could make the family ineligible for benefits or reduce the size of the payment. Empirical evidence supports such predictions. For example, Terrell et al (1996) report that the presence of an unemployed spouse lowered the hazard of exit to employment of UA recipients by 72 percent for females and by 82 percent for males. Boeri (1997) reports similar effects for Poland. It must be noted, however, that UI benefits also reduce labor supply of family members of the recipient through the income effect. For example, Cullen and Gruber (cited in Gruber 1999) find that the labor supply of wives of unemployed workers is very responsive to unemployment benefits received by their husbands: a one-dollar increase in the unemployment benefits of a husband reduces the earnings of his wife by 36 cents.

Third, UA is likely to create perverse entitlement effects. For example, young individuals might claim to be unemployed for purposes of collecting benefits even though they may not be seriously searching for work or engaged in training.

Fourth, UA may discourage savings, because capital enters the income and asset tests (Atkinson and Micklewright, 1991).

Summarizing the evidence, Vroman (2002) notes that the disincentive problems related to UA have been less researched than those related to UI. He notes, however, that a related body of literature – the analysis of the work disincentives of social assistance programs – finds that high effective marginal tax rates on family income create disincentives for social assistance recipients to work. High effective tax rates (or 'clawbacks') are produced by the reduction of benefits when family income exceeds the threshold allowed for the receipt of social assistance. Vroman's analysis of the Australian UA system suggests that a lower income-guarantee would probably result in shorter spells of unemployment (although no hard evidence is presented). He also reports that part of the reason for Australia changing to a more individualized UA system in 1995 was to encourage work among other persons (often wives) in families where one member is unemployed. Suggestive of incentive problems are frequent changes in Australia's activation policies (see Box 2).

To improve labor supply incentives, current public discussions in Australia consider some form of wage subsidy for those with low wage rates and/or hours (such as the Earned Income Tax Credit in the United States). The attractive feature of an EITC is that it raises the marginal reward to work at low hours rather than reducing it as
under the present UA program. However, such a change, if implemented on a scale sufficient to induce changes in behavior, would have serious budget implications.

To conclude, UI and UA produce efficiency effects of similar types. Both may create job search disincentives, increase equilibrium unemployment and make unemployment more persistent. On the positive side, they also automatically stabilize the economy. Job search and activation problems under UA – being a program that ties benefits to low current income – may, in some cases, be even more important than under UI.

**Summary and applicability of UA to developing countries**

The potential for providing benefits to workers with little prior work experience and to informal-sector workers, together with a more effective targeting, is a strong point of UA (see Table 2). But in comparison to UI, the program does not necessarily generate savings, it offers a lower level of protection for high-income workers, imposes larger administrative costs, and creates similar disincentive problems.

In the light of above, what are the implications for the use of UA in developing and transition countries? First, under the typical circumstances in developing countries, one potential advantage of UA – that eligibility does not require prior contributions – in fact renders the program non-viable. With large segments of the labor force either underemployed or unemployed, providing an income-support program which fails to exclude persons without prior work in the formal sector (that is, persons who have not paid program contributions) would be fiscally unsustainable. It therefore seems unavoidable that unemployment assistance programs applied to developing countries also base benefit eligibility on the prior payment of program contributions, as is done, for example, under UI. Second, due to administrative constraints typically faced by low-income countries, few of these countries, if any, could do the required level of monitoring (see Vodopivec and Raju, 2002). Third, abundant informal-sector employment opportunities mean that the problem of employment disincentives for other members of the household is more pronounced than in developed countries. If informal-sector opportunities abound, ineffective monitoring produces large leakages. On the other hand, effective monitoring would reduce overall expenditures but impose large administrative costs and, perhaps, reduce employment and earnings in the informal sector.

To conclude, the applicability of UA program seems to be limited to countries with relatively developed administrative capacity, a small informal sector, and large fiscal pressures, perhaps as a transition system to UI. Transition countries might be possible candidates.

---

**Box 2: Activation Policies under Unemployment Assistance in Australia**

Australia has undertaken a variety of initiatives to promote activation among UA recipients. These initiatives include adjustments in the definition of a ‘suitable job’ and the administration of the work-search requirement.

Prior to the large increase in unemployment in the mid-1970s, emphasis was placed mainly on the acceptance of suitable work (i.e., work that could not be refused while retaining an entitlement to benefits). With a sharp increase in the unemployment-vacancy ratio, there were changes in the definition of suitable work. Guidelines were broadened in 1976 to require acceptance of work in line with local job availability even if it meant a reduction in wages and/or status. By 1989 this definition was further modified to require acceptance of casual, part-time or temporary work.

Moreover, work-search requirements have become more formal, and the evidence of active search emphasized. Changes effective in 1991 required both the short-term and the long-term unemployed to satisfy an activity test. For those unemployed less than twelve months the activity test included active work search or participation in labor-market or vocational training. For the long-term unemployed, there was a requirement to participate in an activity agreement (which could include unpaid volunteer work) intended to secure re-employment but tailored to individual circumstances. Further changes in the activity test became effective in 1995, when increased emphasis was placed on the early identification of those recipients who were likely to be unemployed long term.

Source: Vroman (2002).
Table 2. Summary of factors affecting the choice between UI and UA*

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Weaknesses</th>
<th>Key country specific features</th>
</tr>
</thead>
</table>
| **Unemployment insurance** | • Provides good protection (wide pooling)  
• Performs well under idiosyncratic, sectoral, and regional shocks  
• Acts as an automatic stabilizer and thus moderates the severity of contractions | • Creates re-employment disincentives  
• Increases the equilibrium unemployment rate  
• Contributes to the persistence of unemployment  
• Susceptible to political pressures  
• Does not cover informal-sector workers | • Strong administrative capacity to monitor continuing eligibility  
• Modest informal sector  
• Low political risk  
• Decentralized or encompassing wage bargaining structure – wage moderation effects  
• Low payroll taxes  
• Low share of underemployed workers  
• Low incidence of private transfers (unemployment insurance may be welfare-reducing if it breaks down social fabric that maintains private transfers) |
| **Unemployment assistance** | • In comparison to unemployment insurance:  
• allows for the participation of workers with little prior work experience and informal sector workers  
• more progressive  
• Other strengths similar | • The failure to exclude persons without prior work experience (and hence without payments of program contributions) would make the program fiscally unsustainable  
• offers less protection for high-income workers than unemployment insurance  
• imposes larger administrative costs  
• Reduces the labor supply of family members  
• May stigmatize participants | • Similar as under unemployment insurance, additional capacity needed for means-testing |

*See Vodopivec and Raju (2002) for a broader discussion of the factors and the effects mentioned in the table.
References


