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Title: Comment on "Income Risk and the Benefits of Social Insurance: Evidence from Indonesia and the United States"

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insurance would plausibly be effective at alleviating such costs, though, is a separate question that merits further investigation.

Comment Mario B. Lamberte

The paper empirically shows that idiosyncratic unemployment shocks lead to consumption fluctuation of similar magnitude in the United States and Indonesia. One may conclude from these results that developing economies like Indonesia have adequate social insurance because they can smooth consumption paths in the face of shocks despite the absence of formal social insurance similar to those that can be found in developed economies. If so, the implication is that formal social insurance for developing economies offers small marginal welfare gains. However, this may not necessarily be the case. By developing a normative framework, Chetty was able to demonstrate that a small drop in consumption after a shock can be attributed to either of the two: (a) agents are able to easily and inexpensively smooth consumption by borrowing or through informal insurance mechanisms, or (b) agents are risk averse to fluctuations and are inclined to undertake costly consumption-smoothing actions. In the first case, formal social insurance will yield small marginal welfare gains, while in the second case the same will generate large marginal welfare gains. He then went on to provide three sets of evidence for the presence of high risk aversion in Indonesia. This being the case, formal social insurance can therefore yield large marginal welfare gains.

One of the interesting proofs offered by Chetty that point out the possibility of having high risk aversion in Indonesia is that households undertook costly consumption-smoothing methods by reducing educational expenditures on children to deal with temporary idiosyncratic shock. As is well known, the Philippines was also adversely affected by the recent Asian financial crisis, and there were pieces of evidence that households attempted to fend off a decline in consumption by making some adjustments. Reyes et al. (2001, 168), for instance, made the following conclusion from their analysis:

Even if figures from different data sources did not match, still it was clear that the crisis had the following effects: (1) enrollment in both elementary and secondary school levels had increased but at a lower rate than the usual rate; (2) households had allowed their older children already in school to continue, but postponed the enrollment of new entrants both

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at the elementary and secondary levels; (3) dropout rate of those already in school was not affected in the elementary and private secondary school but increased in public secondary schools;¹ and (4) children had smaller food and transportation allowances.²

Given the previous, the Philippines could be in the same league as Indonesia as far as this paper is concerned.

The inverse relationship between the drop in consumption and risk aversion is key to the paper's argument that formal social insurance can have large marginal welfare gains. Since the drop in consumption in the face of idiosyncratic shock has been observed to be small in Indonesia, empirically proving the existence of high risk aversion becomes crucial. While I agree with the author that a la Binswanger method of inferring risk aversion can lead to misleading results, however, I still feel uncomfortable with the author's method of inferring risk aversion. Take for example the first indicator of risk aversion that is based on average household income cited by the author. One can imagine a situation wherein two groups of households have the same average household income, yet one may show greater risk aversion than the other. That is, when faced with two investments with the same expected return but two different risks, one prefers the one with the lower risk. Another is labor supply response. When some members of the family are involuntarily unemployed, looking for a menial job while the household head is temporarily unemployed may not be a costly labor response. Unfortunately, I could not offer an alternative method for empirically verifying degrees of risk aversion of households.

Assuming that high risk aversion is present in developing economies, an important issue that must be addressed, which the paper has intentionally not covered, is how to finance such a formal social insurance system. Most developing economies are usually confronted with a tax structure and tax administration system that is inefficient, resulting in low tax effort. This cannot be easily fixed in a reasonably short period of time, and institutions to run a social insurance scheme are either absent or inefficient, thereby exposing such scheme to a greater moral hazard problem. That is why the role of an informal insurance system and informal credit market as consumption-smoothing mechanisms cannot be underemphasized in developing economies. Unfortunately, the author has not examined in detail the importance of these mechanisms relative to risk aversion in Indonesia. In the Philippines, for instance, 63 percent of households surveyed availed from

1. This may mean that poor households who normally send their children to free public high school education were more adversely affected by the crisis and asked older children to leave school to save money (i.e., food and transportation allowance) and probably to put them in the labor market.

2. It could be that parents force their children to consume cheaply priced, but low quality food and to walk to school instead of taking a bus, jeepney, or tricycle. So, while children continue to go to school, their school performance suffers.

credit during the crisis period mainly from informal money lenders (Reyes et al. 2001). Of the amount borrowed, 27 percent went to support school expenses of children; 21 percent to pay for medical expenses of sick household members; 19 percent for house repair; and another 16 percent to support household activities. Borrowing from the informal credit market could be a less costly response than reducing human capital accumulation. While I agree that NGOs are not a reliable source of social insurance, relatives and neighbors are known to fill that gap to a certain extent.

Reference

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