A livelihood portfolio theory of social protection

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Livelihood portfolio decisions within the welfare pentagon

We make use of the basic economic assumption that individuals and households[1] maximize income under constraints. Furthermore we assume that all households face the risk of becoming poor at a certain point in the future. In other words, households are assumed to face the risk that they are not (no longer) able to fulfill the needs of their members, today as well as tomorrow. To prevent this risk from materializing, households smooth their consumption over time, setting aside part of their resources to finance future consumption. Additionally, when it becomes clear that income does (will) not suffice, households can seek alternative funding for the expenditures. When these measures are effective, households are able to maintain a particular welfare level, even when income falls short. Being able to generate income (wealth – "income" in this context is not limited to monetary resources) reflects the most important dimension of well-being since its reflects households' capacity to satisfy the needs of their members "today". Being able to smooth consumption reflects another important dimension of well being as it reflects people's capacity to satisfy their (basic) needs "tomorrow", despite the existence of risks and the occurrence of shocks[2]. In this section we argue that migration is an income generating as well as consumption smoothing strategy.

The welfare pentagon represents the five core institutions that households use to satisfy current and future needs in a given society: family, markets, social networks, membership institutions and public authorities (see Figure 1a).[3] Even though historical and geographical appearances differ, these institutions are found in all societies across time and locations. The relevance of each institution and the exchanges between households and these institutions though may differ by society and over time. It is assumed that households make decisions on their income generation and consumption

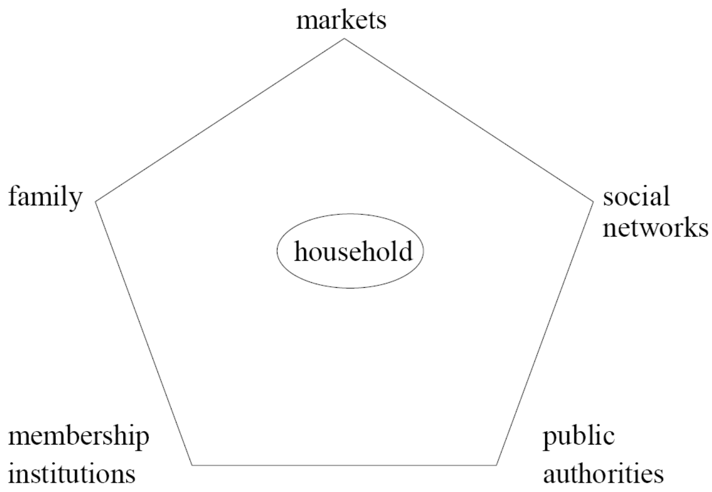
[1] We juxtapose individuals and households in the explanation of the theory; in the end individuals can be regarded as single person households. When individual behaviour is part of a household strategy, the theory becomes more complicated as the relationship between the households members have to be taken into account. The theoretical framework does not ignore that this might be the case, but we do not want to complicate the theoretical explanation at this stage.

[2] Studies analyzing the relationship between income and consumption show that, over time, household consumption is considerably smoother than income; a reduction (increase) in household income is not accompanied by a similarly large decline (increase) in consumption. Although there is considerable evidence that consumption smoothing takes place in both developed and developing countries, the underlying smoothing strategies actually used by households in different societies are highly context dependent, but basically follow a similar pattern. Mechanisms that work for one group, country or region do not work for others or are not accessible for other groups or to people living in a particular area. The economic literature typically analyzes consumption smoothing behaviour following two approaches; the first approach models household behaviour using a permanent income model or risk-sharing model and focuses on the overall smoothness of consumption vis-à-vis income flows (see Deaton, 1992 for an overview). The second approach models and tests particular consumption smoothing mechanisms for specific groups of households or regions (see for instance Dubois *et al*, 2006; Hoogeveen, 2001; Dercon, 1998, Ligon 1998, Udry 1994 and 1995; Rosenzweig, 1988; Rosenzweig and Wolpin, 1993; Kochar, 1999 and 2004, Alessi and Lusardi, 1997).

[3] The Welfare pentagon is a central and distinctive element in the 'Social Risk Management' approach as developed by de Neubourg (2002) and de Neubourg & Weigand (2000). The Social Risk Management framework is formulated to analyze the role and scope of public interventions and foremost, but not exclusively, that of public social protection policies.

smoothing activities by choosing a specific "production point" in the 5-dimensional space defined by the welfare pentagon.

Figure 1a: The Welfare Pentagon



Source: de Neubourg (2002a)

Households use the institutions of the welfare pentagon in their livelihood strategy in order to generate income but also to smooth consumption; labor markets, product markets and capital markets allow households to trade and exchange in order to secure resources to satisfy the main needs at a certain moment. On the labor market households exchange effort for a (future) wage; on product markets households trade effort (producing a product or service) for a (future) profit (or in exchange of another good or service); on the capital market households trade current income for future income by investments, savings, insurances, borrowings and the like. Families, social networks and membership institutions help to address the livelihood risk by means of various (and different) mechanisms of solidarity (and exchange). Membership institutions are institutions of which individuals can become a "member" and from which they can resign (households or individuals enter and exit membership institutions). Examples of such institutions are unions, mutual insurance companies, religious organizations, co-operatives or neighborhood associations. As the fifth corner of the welfare pentagon, public authorities can assist households directly by means of public social protection (pension schemes, child benefits, unemployment insurance and other forms of social insurance) but also indirectly by enforcing contracts through a judicial system, introducing legislation aimed at correcting market failures (such as minimum reserve requirements for banks so that the savings of the households are guaranteed) and many other public actions. Although it is hard and unusual for households to go without the institutions of a welfare pentagon, households can also internalize income generating activities and consumption smoothing by autarchic home production, accumulating physical assets or holding cash savings.

In order to be able to follow a particular income generating and consumption smoothing strategy, households and individuals need *access to the relevant institutions* of the welfare pentagon. Obtaining a social security benefit requires access to the public authorities that control the social benefit; obtaining a (legal) wage depends on your access to the (legal) labor market; getting support from a family member implies having access to a family. In addition to access to a particular institution, specific income generating and consumption smoothing strategies typically also *require some kind of asset or capital*. Assets (capital) can be financial (cash, money on a bank account, savings, stocks, a credit line), physical (land, house, life stock, machines, jewelry), human (education, skills, time), social (family ties, acquaintances, trust) or collective (citizenship, contribution record). For instance, households can buy insurance against certain risks on financial markets using part of their financial assets to pay the insurance premium. Alternatively, households can be insured for certain risks by public authorities through paying taxes or social insurance contributions or simply by being a citizen or a legal resident. On the other hand, they can rely on social networks or family to generate income or compensate them after a shock occurs. Depending on the characteristics of these arrangements a social input is required. This input can take the form of a promise of reciprocity, a 'good' reputation or a family relation. The need for assets or capital that can be mobilized when income generation or consumption smoothing is sought brings us to a very peculiar aspect of the welfare pentagon. The institutions of the welfare pentagon are present but their role in income generation or consumption smoothing can only be effectively "requested" when the individual or the household has a certain amount of capital available: human capital is required to enter the labor market, social capital is needed for making use of families and networks, political capital is needed to use public services, etc.

Inequality, capital and investments needed

The amount of all forms of capital available to a person or a household, however, is neither fixed nor equal between individuals and households. The amount of capital available by individuals (households) is endowed or acquired by investments.

Individuals (households) differ in their initial (capital) endowments due to two main reasons. Firstly, they are not equal in their capacity to generate wealth. This originates, in turn, in two types of differences between them: on the one hand, they differ in intrinsic productivity, in age, in health and in other personal characteristics; on the other hand, they differ in immediate constraints such as household composition (e.g. single parents may have less opportunities to earn a living in the formal labor market). Secondly and at least as important, individuals are "born in an income distribution" (allowing for endowed wealth to be passed from past generations to present ones). These are important differences because their existence implies that households differ in the access to the institutions and in the endowed capital available related to each of the institutions of the welfare pentagon. This means that individuals (households) differ in their income generating opportunities and in their access to the consumption smoothing channels. In other words, individuals (households) differ in their initial capacity to follow a successful livelihood strategy (that means a strategy that allows them to fulfill their needs and to smooth consumption to a degree that needs can always be fulfilled).

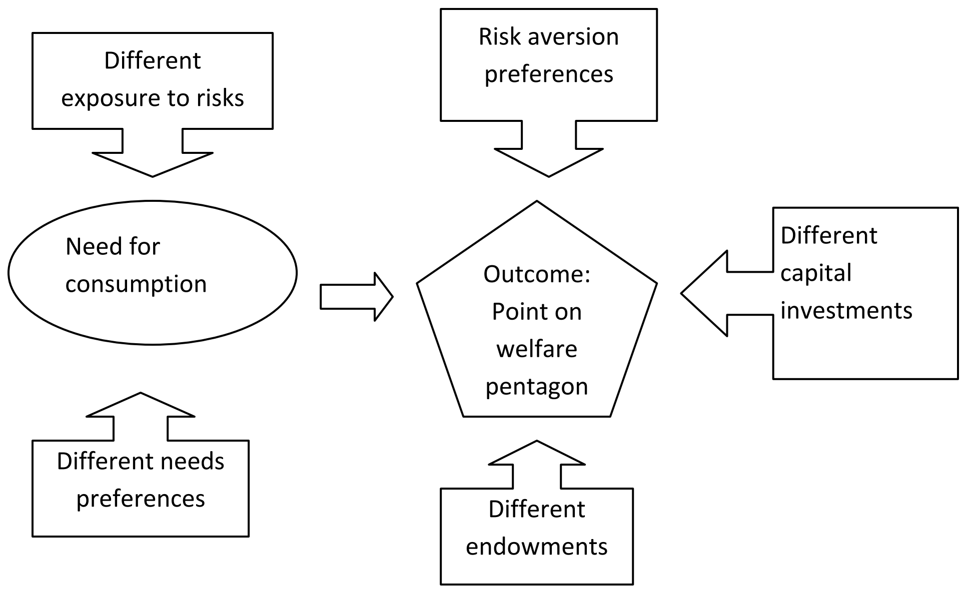
The necessary capital to use one of the institutions (channels) of the welfare pentagon can, however, also be acquired by making investments. Once investments are made, the capital is available to be used to mobilize an institution of the welfare pentagon to generate income or to smooth consumption. This means that availability of all forms of capital is co-defined by various forms of investments that the individuals (household members) have made previously into the various types of capital; the returns on these investments are the collaterals that are implicitly or explicitly used when a welfare pentagon channel is activated to generate income or to smooth consumption. The institutions of the welfare pentagon are thus not only used to generate wealth or smooth consumption but the effectiveness of the welfare pentagon institutions in providing individuals (households) with income generating opportunities or consumption smoothing options, is a function of the investments made by the same individuals (households) into building all forms of capital with each of these institutions[4] and by the initial endowment available to each individual (household).

[4] A exception may be some charity institutions (a special form of membership institutions); to some charity institutions access is provided without building up capital prior to using the services of the charity organization. Remark that this does not hold for all charity organizations since some of them may require membership for

Households also differ in their exposure to risks (meaning that some households are plagued by more "bad luck" than others) and in their preferences. Two sets of preferences are important in this respect: the preferences defining the "needs" of the household members and the preferences regarding the degree of risk aversion they find acceptable.

As a result of the differences spelled out above (initial endowment, risk exposure, needs definition and degree of risk aversion), households adopt different income generating and consumption smoothing strategies or in other words, households differ in their livelihood portfolio or in their particular place in the 5-dimensional space defined by the welfare pentagon. The theoretical framework allows households to choose many "points of welfare production within the 5-dimensional welfare space" all leading to the satisfaction of their needs. As already indicated, several institutions are active in providing assistance with income generating activities or consumption smoothing strategies. A part of the population may not have access to a particular income generating activity or consumption smoothing channel because it lacks the required capital/assets to establish an exchange relationship with the institutional counterpart related to that channel (institution). Figure 1b illustrates the livelihood portfolio decision and the different factors affecting it.

Figure 1b: The livelihood portfolio decision



The results of the differences in the economic activities of households (production points in the welfare pentagon space) lead to a welfare position for individuals and households and to a corresponding income distribution on the aggregate. In that distribution, some households can satisfy their needs and smooth consumption and some others are "poor" in the sense that they have not enough means to guarantee that their needs are always satisfied.

State assisted social protection

Given the inequalities in the initial capital endowments of individuals and households and providing that households and individuals differ in their possibilities to invest in financial, social and political capital[5], public authorities in many countries have decided to assist households in organizing social

some time or the promise of membership in the future (as is for example the case for some religiously inspired charity organizations).

[5] For simplicity's sake, we ignore in this note problems of endogeneity relating livelihood portfolio options and -choices to inequalities between individuals in initial endowments in all forms of capital. It is far from excluded, however, that constraints met by individuals and choices made by individuals are related to their position in the income distribution (or in the distribution of capitals in the welfare pentagons channels, thus their initial endownments). The degree of risk exposure of households might not just be randomly distributed among

protection. They do so by using various social policy instruments (see module 5) including providing goods and services for free (or at low costs), regulating financing or producing (social) insurance schemes, disbursing direct social cash transfers and many more. Part 2 explains the policy portfolio choices that EU countries have made and are making. Before turning to the empirical analyses of these choices, two important remarks remain to be made.

It is important to note that welfare pentagon channels are substitute for one another. That means that if public authorities step in to provide social protection, the other channels of the welfare pentagon do no longer need to intervene (or will reduce their inputs in providing social protection). If for example public authorities provide free[6] education or free health care, households do not have to activate other channels to make sure that education or health care are provided. This also means that if public authorities withdraw or lower their inputs in providing social protection, the other channels of the welfare pentagon will have to make a larger effort to assist households in meeting their needs and/or households will have to activate themselves other channels in order to make sure that their needs are satisfied. If for example, public authorities would withdraw from providing pension insurance, households would either have to save themselves to provide the necessary income at retirement age using the market channel or households will have to rely on transfers from others at old age such as children and grandchildren, friends and charity (the family, social networks and membership organization channels in the welfare pentagon).

The second important note on state assisted social protection refers to inequalities in the outcomes of the lack of government interventions in social protection. If the state is not assisting in providing social protection, the burden is shifted towards individuals with higher risks (see also footnote 5) and the burden is more difficult to bear for individuals and households with less resources (individuals/households with smaller initial endowments or simpler said “poor” households). Therefore the state often assists households to satisfy their needs by providing social protection in order to distribute the costs more evenly over the individuals/households and because for certain forms of social protection (or for some risks) other pentagon channels may fail (market failure, family failure, social network failure).

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households in a particular society but may be positively biased towards the “poorly endowed” households, meaning that poor households run higher risks to be confronted with “bad luck” for example because they are concentrated in neighborhoods with a higher than average propensity to e.g. crime, physical damage due to earthquakes, flooding, drought, bad harvests and health hazards due to “bad conditions” in general. As indicated, individuals and households set their needs level themselves; besides the basic conditions to survive, household can choose the need level that needs to be realized at time “t” and guaranteed by consumption smoothing in the future. Moreover, individuals and households define themselves the actual degree of risk aversion deemed acceptable. If the definition of needs and levels of risk aversion are related to one’s position in the income distribution, than households with a low level of endowment in terms of access to the welfare pentagon channels may adopt a behavior that traps them into this low welfare level in two ways. Firstly, they choose an ambition level that is lower than potentially could be reached and secondly they choose consumption smoothing strategies that are less effective. Moreover, they may be confronted with higher risks exposure and with more investment constraints in all form of capital. The endogeneity in terms of channel choices, investment constraints and risk exposure do not change the theory, but complicates it and make both empirical analyses and policy interventions more troublesome.

[6] Note that “free” is inaccurate as a qualification. Public authorities will have to pay for the services that are provided. This refers to need for social protection financing: see module 9.