

Achieving Effective Social Protection  
for All in Latin America and the Caribbean



# Achieving Effective Social Protection for All in Latin America and the Caribbean

*From Right to Reality*

Helena Ribe  
David A. Robalino  
Ian Walker



**THE WORLD BANK**  
Washington, D.C.

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1818 H Street NW  
Washington DC 20433  
Telephone: 202-473-1000  
Internet: [www.worldbank.org](http://www.worldbank.org)  
E-mail: [feedback@worldbank.org](mailto:feedback@worldbank.org)

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1 2 3 4 13 12 11 10

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ISBN: 978-0-8213-8398-8  
eISBN: 978-0-8213-8399-5  
DOI: 10.1596/978-0-8213-8398-8

Cover art: Carla Robalino  
Cover design: Quantum Think, Inc.

#### **Library of Congress Cataloging-in-Publication Data**

Ribe, Helena, 1949-

Achieving effective social protection for all in Latin America and the Caribbean : from right to reality / Helena Ribe, David A. Robalino, and Ian Walker.

p. cm. — (Directions in development)

Includes bibliographical references and index.

ISBN 978-0-8213-8398-8 (alk. paper) — ISBN 978-0-8213-8399-5

1. Social security—Latin America. 2. Economic assistance, Domestic—Latin America. 3. Public welfare—Latin America. I. Robalino, David A. II. Walker, Ian, 1957- III. World Bank. IV. Title.

HD7130.5.R53 2010

361.98—dc22

2010015476

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## Foreword

Latin America remains the world's most unequal region, and one where poverty is therefore greater than it should be, given its level of economic development. In the last decade, however, inequality fell in 12 of the 17 Latin American nations for which comparable data was available, and a number of studies have attributed a non-trivial part of that decline to an expansion in the continent's social protection systems. In some countries, an important share of the reduction in absolute poverty appears to have been driven by large-scale social protection innovations, such as conditional cash transfers and non-contributory "social" pensions.

Nevertheless, the very process of experimentation and organic growth by which social assistance and social insurance programs have developed in many countries has spawned an incomplete and fragmented system, posing a number of challenges to the region's policy makers. Contributory social insurance coverage remains too low, and restricted to formal sector workers. Redistribution within the social insurance system is usually opaque and often regressive. Fragmentation and ill-designed redistribution also create unintended disincentives for work and savings. And improvements in the effectiveness with which social insurance instruments promote investment in human capital and facilitate transitions into good jobs remain both necessary and possible.

Building on careful, detailed analysis of a wealth of data on social protection programs across Latin America and the Caribbean (LAC), this book addresses these various challenges in a thorough yet accessible manner. Although the analysis is comprehensive, the authors focus primarily on three fundamental questions that must be faced by any effort to strengthen social protection in the region: How to protect the most vulnerable without promoting informality and dampening incentives to work and save. How to ensure that scarce public resources are used for subsidies that are transparent, fair, and effective and not for badly targeted and regressive benefits for formal sector workers. How to reinforce human capital development so the more mobile workers the region needs are able to insure themselves through savings or risk pooling arrangements, reducing vulnerability and the need for subsidies.

In providing thoughtful, evidence-based answers to these questions, this volume makes an important contribution to a growing debate among policy makers and social actors in LAC about the costs and inefficiencies of what are at present dualistic systems of social insurance for formal workers and social assistance for others. By necessity, that contribution is informed by a deep understanding of how Latin American labor markets work, and especially of the challenge posed by the prevalence of informality.

The authors develop a compelling, parsimonious conceptual framework for the general principles of social protection reform, highlighting the importance of the behavioral reactions of workers, firms, and service providers to the rules and incentives embedded in social protection policies and programs. But their proposals are also rooted in an in-depth knowledge of the complex realities of the region. They recognize that the starting points, constraints, and social choices will vary by country, and avoid the trap of recommending a simple blueprint. Rather, the book invites policy makers everywhere to “step up” to the challenge of building an integrated social protection system that treats the population equitably, provides an inclusive safety net for all, promotes efficiency in service provision, and strengthens incentives to build a more flexible human capital, to work, and to save. If that invitation is taken up, the results could combine greater equity with a boost to the region’s economic performance.

Augusto de la Torre  
Chief Economist  
Latin America and the Caribbean Region  
The World Bank

## Acknowledgments

This book highlights the main findings of a regional study by the World Bank, *From Right to Reality: How Latin America and the Caribbean Can Achieve Universal Social Protection by Improving Redistribution and Adapting Programs to Labor Markets* (Ribe, Robalino, and Walker, with Kurowski, Mason, Rofman, and Sánchez Puerta, forthcoming). This was commissioned by the Chief Economist's Office and prepared by the Social Protection Unit in the Latin America and the Caribbean Region of the World Bank under the supervision of Augusto de la Torre and Helena Ribe. Andrew Mason was the initial task team leader, and David Robalino became the task team leader until completion. Chapter authors for the main study included Javier Baez, Andrew Mason, and Helena Ribe (recent trends in Latin America and the Caribbean's [LAC's] social protection [SP] systems); David Robalino and Eduardo Zylberstajn (labor markets); Rafael Rofman and David Robalino (old-age income support); Christoph Kurowski and Ian Walker (health); Francesca Lamanna, Helena Ribe, and Ian Walker (income support safety nets); Maria Laura Sanchez Puerta and David Robalino (unemployment insurance and active labor market programs); and David Robalino, and Ian Walker (interactions between different elements of the SP systems and cross-cutting challenges). Background papers and other valuable inputs came from Pablo Acosta, Rodolfo Beazley, Fabio Bertranou,

Ramon Castano-Yepes, Aline Coudouel, Wendy Cunningham, Vanessa da Silva Moreira, Mario di Filippo, Alvaro Forteza, Ariela Goldschimit, Jason Hobbs, Theresa Jones, Ricardo Charles Manzano, Edmundo Murrugarra, Christina Novinsky, Francisco Ochoa, Susan Parker, Jose Luis Salas, Manuel Salazar, John Scott, Veronica Silva, Maria Concepcion Steta, Sarah Thomson, Elio Valladares, Manuela Villar, Alejandro Yepes, and Eduardo Zylberstajn. The team gratefully acknowledges the advice and comments from Veronica Alaimo, Caridad Araujo, Laura Chioda, Tito Cordella, Augusto de la Torre, Pablo Fajnzylber, Francisco Ferreira, Margaret Grosh, Marcelo Giugale, Keith Hansen, Richard Hinz, Robert Holzmann, Dorothy Kronick, William Maloney, John Nash, Ana Revenga, Gonzalo Reyes, Jamele Rigolini, Jaime Saavedra, Ilias Skamnelos, Andras Uthoff, Salvador Valdés, Milan Vodopivec, and Hélio Zylberstajn. Special thanks to Fiona Mackintosh, Lerick Kebeck, Sandra León, and Julia Nannucci, who contributed to the editing and production of this report.

# Abbreviations

AFDC	Aid for Families with Dependent Children program
ALMP	active labor market program
CCT	conditional cash transfer
DB	defined benefit
DC	defined contribution
EAP	economically active population
EMTR	effective marginal tax rate
GDP	gross domestic product
IMSS	Mexican social security institute
IRR	internal rate of return
LAC	Latin America and the Caribbean
LRMS	labor market risk management system
NDC	notional defined-contribution
NHS	national health service
NQF	national qualifications framework
OECD	Organisation for Economic Co-operation and Development
PAYG	pay-as-you-go
PLANE	<i>Plan Nacional de Empleo de Emergencia</i>
PPP	purchasing power parity
SHI	social health insurance

SI	social insurance
SP	social protection
UI	unemployment insurance
TANF	Temporary Assistance for Needy Families
UISA	unemployment individual savings accounts
VAT	value added tax

## Overview

*Slow progress in improving the coverage of Latin America and the Caribbean's (LAC's) traditional social protection (SP) programs, combined with the deepening of democracy, have led to calls for a new social contract to provide effective social protection to all citizens.* This study reviews the state of SP in LAC, showing that coverage gaps, low benefits, and inequity continue to plague many countries. Such problems are apparent in pensions, health, unemployment insurance, income support, and labor market programs. As a result, many households are insufficiently protected against the idiosyncratic shocks that can affect anyone or against systemic shocks to the economy as a whole. This problem has been made more pressing by the global economic crisis, which threatens to increase poverty and further undermine the security of many households.

*This book highlights the main findings of a regional study by the World Bank, **From Right to Reality: How Latin America and the Caribbean Can Achieve Universal Social Protection by Improving Redistribution and Adapting Programs to Labor Markets** (Ribe, Robalino, and Walker, forthcoming).* It shows that the reforms of the past two decades have expanded SP coverage to the most vulnerable groups, but the process has been uneven and ad hoc, creating a two-tier, fragmented system. As is well known, LAC's traditional SP system, based on mandatory

employee and employer contributions to social insurance (SI) funds, including pensions, unemployment insurance, and health insurance, was truncated, inequitable, and fiscally unsustainable. Two decades of reform efforts have produced important advances. In many countries, contributory SI has been modernized, for example, through pension reforms to improve fiscal sustainability and to correct distorted incentives. At the same time, targeted, noncontributory mechanisms have been established to provide income support and health services to those excluded from contributory SI (above all, the poor and informal sector workers). The benefits offered by such programs, however, often are markedly inferior to those from traditional SI and contribute to the fragmentation of the labor market.

*The report analyzes LAC's SI systems and highlights growing concerns about the incentives they may create and the behaviors they may incite on the part of workers, employers and service providers.* It offers an economic analysis of the roots of these problems and suggests a way forward to achieve universal coverage in an equitable manner. Tensions between system components can undermine beneficiaries' incentives to work and to save, can reinforce individuals' and firms' incentives to operate informally, and can induce providers to duplicate services and inflate costs. For example, overly generous safety net programs or badly designed non-contributory social insurance programs may create incentives to informality and undermine contributory SI. The report argues that a coherent overall vision for the SP system should be established if such problems are to be understood and resolved. The goal is to turn the theoretical right to social protection, which is enshrined in many of the region's constitutions and laws, into a reality for all of LAC's population.

*A central message of the report is that SP systems need to respond to the realities of LAC's labor markets, especially the prevalence of informality and frequent changes of employment.* It will be difficult to expand the coverage of contributory SI so long as access is linked to having a formal sector labor contract, informal sector workers are excluded and rules on benefit entitlement are slanted against people who move jobs. Coverage of SI is also unlikely to expand significantly without redistributive mechanisms that target individuals with limited savings capacity and the long-term poor. It is important to make these mechanisms more transparent and progressive, and to better integrate them with the general social assistance system.

*Chapter 1 reviews the reforms of the last 20 years and the present state of LAC's SP systems and identifies five challenges facing SP policy makers in LAC:*

- Addressing the limited progress that has been made in extending SI coverage. This is analyzed using new cross-country data on the scope of contributory and noncontributory programs for old-age income support, health, and unemployment protection.
- Reducing the fragmentation of institutional arrangements in SI, which arises, in part, from the ad hoc development of subsidized programs and leads to differentiated provision and benefit adequacy between insurers and population groups.
- Changing the opaque and often regressive nature of financing and redistribution arrangements for SI and the associated lack of financial sustainability for many programs and systems.
- Reinforcing the targeting and poverty reduction effects of income transfer programs, to strengthen their impact on human capital accumulation, improve their crisis response capacity, and ensure that they do not incentivize informality in the labor market.
- Strengthening active labor market programs (ALMPs), to improve the relevance of training programs, and increase the efficiency of the job-search and matching process.

*Chapter 2 develops a proposed policy framework for SP in LAC that would facilitate an effective response to these challenges.* It includes a conceptual framework for understanding the objectives and elements of an SP system, the interactions between instruments and programs within the system, and their impact on the economy as a whole. It then uses this framework to address the challenges outlined in chapter 1 and suggests a way forward for increasing the coverage and adequacy of SP in LAC. The conceptual framework highlights three objectives: (1) consumption smoothing to deal with life-cycle income variations and with short-term health and labor market risks; (2) poverty prevention (the social safety net); and (3) human capital development. It identifies the instruments, financing mechanisms and institutions that can help achieve these goals. The framework emphasizes that—whatever programs, institutions, and financing mechanisms are chosen—a successful SP system will have regard for the behavioral responses of individuals, households, and SP providers to the rules and incentives embedded in the system.

*The chapter identifies a set of principles to improve the coherence of the SP system and expand the coverage and adequacy of benefits, while avoiding perverse incentives to reduce work and savings, to seek informality, or to increase the costs of service provision.* It proposes the expansion of SI to all citizens, regardless of where they work. Contributory systems would be integrated or harmonized and extended to informal sector workers and the poor. To reduce distortions, contributions would be directly linked to benefits, thus eliminating implicit taxes and subsidies. Transparent, progressive subsidies would then be used to help low-income workers with limited savings capacity to access contributory SI. This, in turn, would allow targeted anti-poverty programs such as conditional cash transfers (CCTs) to focus on helping extremely poor and excluded households, with little or no savings capacity, to increase their consumption, strengthen their human capital, and cope with temporary shocks. The governance and design of labor market programs should be strengthened to improve access to “good quality” jobs as a lasting way to reduce poverty and vulnerability. All these changes should be accompanied by better integration and coordination of the components of the social protection system.

*Chapter 3 addresses the detailed implications for specific SP programs.* It summarizes the main recommendations that flow from the conceptual framework and the general approach to reform for the main types of SP programs in LAC: old-age income protection and pensions; health programs; active labor market programs; and targeted income support programs for the poor.

*Chapter 4 discusses the trajectory of reform, showing how these ideas could be implemented in countries with different points of departure.* This report’s review of lessons learned from the successes (and failures) with past SP reforms aims to identify workable principles on which to base a new phase of reforms. The goal should be to move toward a more coherent, integrated, effective, and equitable SP system in the medium term. The problems will not be resolved overnight, and advances will sometimes be small, but a clear vision is needed to help policy makers avoid piecemeal reforms that respond to short-term concerns and minority interests. Nevertheless, the report also argues for a pragmatic and technocratic approach, avoiding “universal models” and emphasizes that the specific policies chosen will depend on each country’s initial conditions and priorities.

The central ideas are simple. To turn the *right* to SP into a *reality* for all the population in Latin America and the Caribbean, *contributory SI* should

be opened up to informal sector workers on an optional basis with adequate financial and institutional incentives; SI benefits should be aligned with the value of contributions; and subsidies should be transparent, targeted to workers with limited savings capacity, and financed out of general taxation. Wherever possible, SI programs covering different populations or risks should be consolidated and their benefits packages harmonized. At the same time, *safety net programs* should be targeted based on poverty criteria and program rules should avoid creating disincentives to work or save. More emphasis should be placed on interventions that *promote human capital* and reduce vulnerability by strengthening links from SP programs to improved health, nutrition, and education outcomes. Policy makers also need to improve the design of ALMPs to help the most vulnerable workers (especially young people entering the labor market and low-income unskilled workers) get better quality jobs and avoid long-term unemployment. Finally, care should be taken to coordinate policies across different types of program to take advantage of potential synergies and cross-effects and to avoid adopting policies with conflicting aims.

***In summary, the report suggests five strategic themes for policy reforms that could help countries in the LAC region move closer to making the right to SP a reality for everyone:***

- *Open up contributory SI programs to all workers*, regardless of where they work. This means maintaining mandatory insurance in the formal sector but also promoting the inclusion of informal sector workers in contributory SI programs on an optional basis, with adequate financial and institutional incentives.
- *Review the mandates of SI programs*. The objective is to make explicit choices about the coverage and benefits to be offered to individuals with different levels of income. These choices need to be adequate but also efficient and affordable.
- *Make subsidies transparent and progressive*. The idea is to remove implicit taxes and subsidies within SI programs and move toward a unified system of subsidies that are targeted based on means. These subsidies would decline gradually as the beneficiary's income rose and would be financed from general revenues. This would make redistribution more progressive and avoid distorting incentives for workers and employers.
- *Make SP systems more coherent* by integrating or harmonizing parallel programs and exploiting opportunities to share savings and insurance pools between risks. Policy makers also need to rationalize the interactions between SI, safety net programs, and ALMPs.

- *Deepen the antipoverty social safety net and develop programs to facilitate access to better jobs.* Cash or in-kind transfers are needed for workers and households in extreme poverty who have no capacity to participate in contributory SI, even with subsidies. A key objective is to ensure that these social safety nets encourage poor households to invest in education, health, and nutrition to avoid the intergenerational transmission of poverty. In parallel, ALMPs are needed to help low-income and low-skilled workers increase their employability and to facilitate labor mobility and job search. This can increase their earnings and reduce their economic vulnerability, thus relieving pressure on other elements of the SP system.

# Introduction

Latin America and the Caribbean (LAC) are known internationally as the home of some of the world's most innovative social protection (SP) programs and policies. In the last two decades, many LAC SP systems have been transformed, and policies and spending on SP have increased in importance in relation to other government policies and programs. Many countries have reformed their pensions systems to make benefits commensurate with savings and to reduce their fiscal exposure to future deficits. Many countries have expanded or introduced targeted social health insurance systems (SHI) that provide free or subsidized health care to the poorest families. Perhaps most noteworthy has been the introduction of well-targeted conditional cash transfer systems that have brought millions of poor families within the scope of SP for the first time and have been adopted as a model by developing countries worldwide.

Notwithstanding this recent progress, much remains to be done to turn the right to social protection—which is enshrined in the constitutions and laws of most LAC countries—into a reality for the majority of their populations. At the heart of this predicament is the very low coverage of *contributory social insurance* (SI), which recent reforms have not resolved. The main difficulty is that the region's mandatory systems for providing pensions, health insurance, and unemployment benefits are not

apt to cover workers in the informal sector, who constitute a majority of the labor force in most countries.

Another problem is that the SI systems in most LAC countries are fragmented, meaning that parallel schemes exist that offer different benefits to different segments of the labor force, even when they make similar contributions. This restrains labor mobility, creates inequalities, and increases costs. To close the coverage gap, several countries have introduced *noncontributory* SI programs (such as social pensions), but in some cases this has created dual systems—worsening fragmentation—and may have created incentives for informality.

In many countries, the SI system redistributes income between plan members through the implicit effect of rules about contributions and benefits. Although the original intention was to favor lower-income plan members, in practice, the resulting redistribution is often regressive. In addition, the resulting implicit taxes and subsidies distort incentives and can induce evasion and other unintended behaviors, such as early retirement or reduced work-search efforts. Implicit subsidies have caused serious problems of overall fiscal sustainability, because in practice, they are not always fully financed by the contributions of plan members and their employers. This results in pensions, unemployment benefits, and health insurance systems running deficits, which must be financed from general taxes on current and future generations.

Similarly, the region's social assistance (SA) programs, which provide targeted transfers to the poorest households, have yet to achieve their full potential in terms of preventing poverty and promoting human capital development. This is, in part, because of the poor quality of health and education services provided to beneficiaries of conditional cash transfer programs (CCTs). In addition, challenges related to the implementation of SA programs in urban areas might undermine targeting outcomes, and the effectiveness of their enrollment and exit mechanisms. For some types of income transfer program, the potential for labor market disincentive effects, similar to those arising from subsidized SI programs, is an issue.

Other challenges are associated with active labor market programs. Many of these programs are not designed adequately to overcome the constraints that make it hard for workers to have access to quality jobs. Training—the main form of support offered in these programs—is often supply driven and it benefits mostly formal sector workers. Job search intermediation services and interventions to increase the labor market opportunities of low-skilled workers, particularly young people, are underdeveloped. The 2008–09 financial crisis has shown that LAC's SP

systems remain ill equipped to provide most workers with adequate protection against shocks. Many who lose their jobs will receive no compensation to tide them over until their next job and will not have access to employment services to help them find work.

The current socioeconomic environment in LAC counties is conducive to addressing these challenges by reforming SP systems. Social consensus is growing on the need for a more equitable distribution of income and for social inclusion and a general recognition that better social protection policies can contribute to achieving those goals.

This book highlights the main findings of a regional study by the World Bank, *From Right to Reality: How Latin America and the Caribbean Can Achieve Universal Social Protection by Improving Redistribution and Adapting Programs to Labor Markets* (Ribe, Robalino, and Walker, forthcoming). It takes stock of recent SP reforms in LAC and charts a way forward to improve outcomes, in terms of program coverage and the adequacy of benefits. It contributes to policy discussions about the design of SI, social assistance, and labor market programs.

The report builds on an extensive literature about the reform of social protection systems in LAC (de Ferranti et al. 2000; Gill, Packard, and Yermo 2004; Baeza and Packard 2006; ECLAC 2006; Levy 2008; and Grosh et al, 2008). A central theme is that a well-functioning SP system must take into account the realities of the region's labor markets, especially the persistence of high levels of informal sector employment, where it is difficult for governments to impose mandates such as compulsory SI. It also should take into account the likely effects of policies and programs on the behavior of their beneficiaries and of service providers, through the incentives and disincentives that they provide to work, to save, to insure, and to operate programs efficiently.

These themes have figured in different ways in the recent literature. Levy (2008), for instance, showed that some subsidized SP systems might be encouraging informality and undermining productivity growth. Baeza and Packard (2006) argued for financing health insurance from general taxation to overcome exclusion problems. Gill et al. (2004) analyzed the failure of many of LAC's funded, defined-contribution pension systems to increase coverage or efficiency. Grosh et al (2008) have highlighted the importance of strong social safety nets that are well-designed and implemented, to help families invest in their futures and manage risk, as well as alleviating their present poverty.

This report moves the debate forward by (1) developing a common policy framework for the region's SP system as a whole, including health

insurance; (2) providing guidelines on ways to extend coverage by rationalizing financing mechanisms and the design of redistributive arrangements; and (3) making the case for improved coordination of policies and programs. The last point is important. To date, the design of SP reforms has not paid enough attention to the impact that one program can have on the performance of others.

The report is organized in four chapters. Chapter 1 describes the point of departure, highlighting the major challenges faced by policy makers in reforming SP systems in LAC, with an emphasis on those issues that apply across all programs.

Chapter 2 presents a vision for the future development of LAC's SP systems. It outlines a conceptual framework that highlights the three SP objectives of smoothing consumption, preventing poverty, and promoting human capital to reduce the vulnerability of the population—for instance by improving labor market opportunities and expanding options to self-insure. The framework shows how different types of SP instruments (such as savings, risk-pooling, and transfer programs) can contribute to achieving those objectives; what institutional arrangements can be used; and what financing mechanisms (such as workers' and firms' contributions and transfers from the general taxation fund) are available. Finally, it highlights how SP instruments can indirectly affect the behavior of individuals and firms, the behavior of SP service providers, and fiscal outcomes. The conceptual framework is used to define a set of principles for how LAC's SP systems might address the challenges of increasing the coverage and adequacy of benefits that were identified in chapter 1.

Chapter 3 explores in detail the implications of this framework for the reform of LAC's SP programs, dealing in turn with pensions, health and unemployment insurance, active labor market policies, and targeted antipoverty income transfers.

Finally, chapter 4 discusses the political economy of reform, highlighting the way in which initial conditions (for example the reforms that are already in place) can affect the path that each country can take toward implementing a more effective and inclusive SP system.

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## CHAPTER 1

# The State of Social Protection in Latin America and the Caribbean: Recent Progress and Pending Challenges

This first part of this report details recent progress in extending social protection (SP) coverage in Latin America and the Caribbean (LAC), presenting new cross-country data on households' access to contributory and noncontributory social insurance (SI), and highlights the future challenges related to the region's SP systems. The discussion covers: (1) SI for pensions, health, and unemployment risks (consumption smoothing); (2) poverty prevention and social safety net programs; and (3) labor market programs to increase access to quality jobs by reducing job search constraints and fostering human capital investment and skills development, especially for the most vulnerable.

We start with a brief review of some of the most important reforms of the last 20 years. We then identify five principal challenges facing SP policy makers in LAC:

- Addressing the limited progress that has been made in extending SI coverage. This is analyzed using new cross-country data on the scope of contributory and noncontributory programs for old-age income support, health, and unemployment protection.

- Reducing the fragmentation of institutional arrangements in SI, which arises, in part, from the ad hoc development of subsidized programs and leads to differentiated provision and benefit adequacy between insurers and population groups.
- Changing the opaque and often regressive nature of financing and redistribution arrangements for SI and the associated lack of financial sustainability for many programs and systems.
- Reinforcing the targeting and poverty reduction effects of income transfer programs, to strengthen their impact on human capital accumulation, improve their crisis response capacity, and ensure that they avoid labor market disincentive effects.
- Strengthening the region's active labor market programs (ALMPs), improve the relevance of training programs, and increase the efficiency of the job-search and matching process.

### **Recent Developments and Challenges in SP Systems**

Many LAC countries have redesigned their *SI* programs to make them more financially sustainable and to create stronger incentives to work and to save. This has led to major advances toward equitable, more sustainable pensions systems in which retirement benefits (beyond a minimum floor) are proportional to the amount that each worker saves during their working life. In health, the development of stronger national health services (NHSs) and of targeted, subsidized health insurance (HI) schemes have improved access to good quality health services and enhanced the financial protection of poor families. Some countries have strengthened unemployment insurance (UI) and reformed severance pay by developing unemployment individual savings accounts (UISAs). These savings accounts provide workers with income protection against job loss, without undermining the incentive to work, and can be combined with targeted redistributive arrangements to protect low-income workers from unemployment risks. Because the reform of pensions, health systems transfers, or subsidies is always politically difficult, these are considerable achievements.

Many countries have rationalized and expanded their *social safety nets*, moving away from ad hoc assistance programs and price subsidies toward well-targeted cash transfers. Conditional cash transfer (CCT) programs have now been adopted by most countries in the region, benefiting millions of the poorest households who previously were excluded from SP. The CCT model, which was first adopted in LAC, is now being

used around the world. The model introduced the requirement that recipients of transfers should make use of basic health, nutrition, and education services. In doing so, the CCT approach has led to a sea change in the attitudes of policy makers in many developing countries toward the rationale for providing income support to the poorest households. Previously, many policy makers had been concerned about recipients becoming dependent on benefits and whether such programs were sustainable over the long term. Such concerns had blocked the development of safety nets in many countries.

Progress has also been made in making *labor market programs* more effective, through interventions that simultaneously address problems related to a lack of skills (technical or soft) and those related to job search constraints, especially for low-income young people and unskilled workers. The *Jóvenes* programs, which have been established to support young people in the school-to-work transition in several Latin American countries, are a good example. These programs have been successful in increasing the number of job opportunities and the level of wages. Their success can be attributed to several factors: (1) they provide training that is driven by labor market demand, (2) they use a competitive bidding process in choosing training providers, and (3) they offer consistent financial incentives to both employers and employees.

These advances are important, but they have not resolved all the problems. This report argues that policy makers now need to address five major challenges facing LAC's SP systems.

### **Challenge I: Contributory Social Insurance Coverage Remains Low and Limited to the Formal Sector**

A key SP challenge facing LAC countries is the need to expand the coverage of contributory SI to a much larger share of the workforce. There is no single, unified indicator of SI coverage, but program coverage data derived from household surveys for this study tell a common story—in most LAC countries, only a minority of workers has access to pensions or to contributory health insurance and UI. In general, low-income workers, those working in small firms, and those living in rural areas are less likely to be covered by insurance. Formal sector employees often enjoy a multidimensional package of social benefits, whereas informal sector workers and the unemployed have only limited access to the SP system.

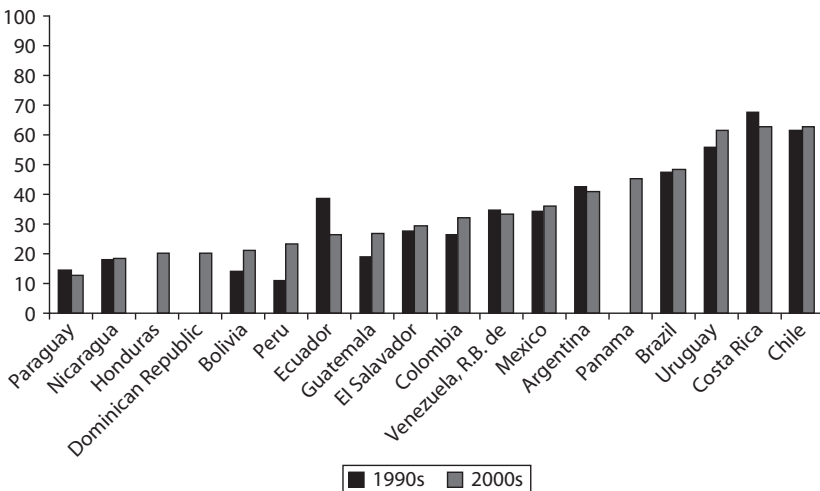
In the 1990s, in most countries in the region, pension coverage rates were below 40 percent of the economically active population (EAP).

Twelve of the region’s 18 countries had coverage rates below 40 percent. Only Chile, Uruguay, and Costa Rica were providing pension protection to more than half of their EAP, while Argentina, Brazil, and Panama covered between 40 and 50 percent. Despite structural reforms that aimed to give workers more incentives to enroll, coverage has increased only slightly. Among 15 countries for which comparable data exist for the 1990s and 2000s, coverage rates declined in five countries, remained almost unchanged in five, and showed a modest increase in five countries (see figure 1.1).<sup>1</sup>

Moreover, pension coverage is skewed against people at the bottom of the income distribution. In the mid-2000s, coverage in the lowest quintile was below 10 percent in 10 of the 18 countries in the sample (ranging from 0.2 percent in Bolivia to 8 percent in Colombia). In contrast, at the other end of the income distribution, coverage was on average nearly 60 percent (see figure 1.2). Chile and Costa Rica are the exceptions, with their coverage being more evenly spread across income groups. In most countries, inequality remained roughly constant between the 1990s and the mid-2000s.

**Figure 1.1 Contributory Pension Coverage in Latin America and the Caribbean, 1990s to 2000s**

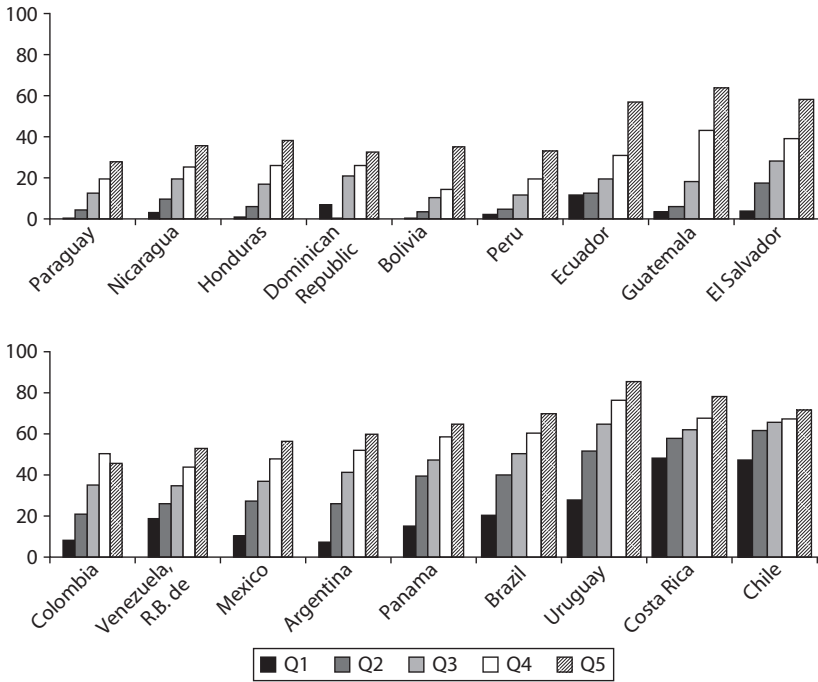
(percentage of the economically active population contributing to pension systems)



Source: Rofman, Lucchetti, and Ourens 2008.

Note: Data are for the year that comes closest to 1995 (for the 1990s) and 2006 (for the 2000s).

**Figure 1.2 Contributory Pension Coverage Rates in Latin America and the Caribbean in the 2000s, by Quintile of per Capita Income**  
*(percentage of the economically active population contributing to pension systems)*



Source: Adapted from Rofman, Lucchetti, and Ourens 2008.

Differences in coverage also are evident by region and type of firm. Coverage in rural areas is only one-third the level in urban areas. Coverage in the primary sector is lower than in manufacturing and services. Coverage in the private sector is lower than in the public sector. Coverage is lower among employees of small firms, among independent (self-employed) workers, and among the unemployed.

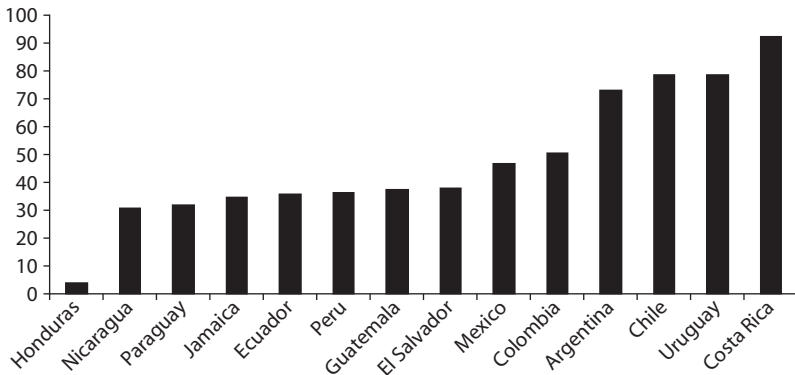
In the great majority of countries in the region, access to health services is a constitutional right. This is reflected in the open access of all citizens to public provider networks or to national health services (NHS). In parallel, most countries operate contributory health insurance systems, which commonly have superior benefits to those provided under the NHS. Coverage of the more generous contributory systems is relatively low. Only four countries have coverage between 70 and 90 percent; all others have coverage below 50 percent and,

therefore, rely primarily on the NHS (see figure 1.3). As a result, a relatively low proportion of LAC's health costs are covered by pooled, pre-paid financing and—in consequence—out-of-pocket health expenditures are relatively high. This particularly affects poor people because—as in the case of pensions—they are less likely to be part of the contributory SHI system. However, access for middle- and low-income workers in Argentina, Chile, Costa Rica, and Uruguay is markedly better than in most other countries in LAC (figure 1.4).

No household data are available on the coverage of unemployment benefits, but the available evidence suggests that a low percentage of the unemployed receive some form of benefit. Most countries rely on severance pay as the main income protection system. Severance pay is unreliable, however, because employers do not provision funds to finance their liabilities with the program and it is difficult to force them to pay. For instance, in Argentina, fewer than 3 percent of unemployed workers receive severance pay. Conversely, in those countries that have developed UI or UISAs, coverage rates are extremely low. Only Brazil has as many unemployment accounts as it has employed workers—in other countries, less than a quarter of the workforce is covered (figure 1.5).

The continuing low coverage of LAC's SI systems is not surprising. LAC governments designed the systems based on the Bismarck model in which SI entitlements are proportional to the mandatory contributions

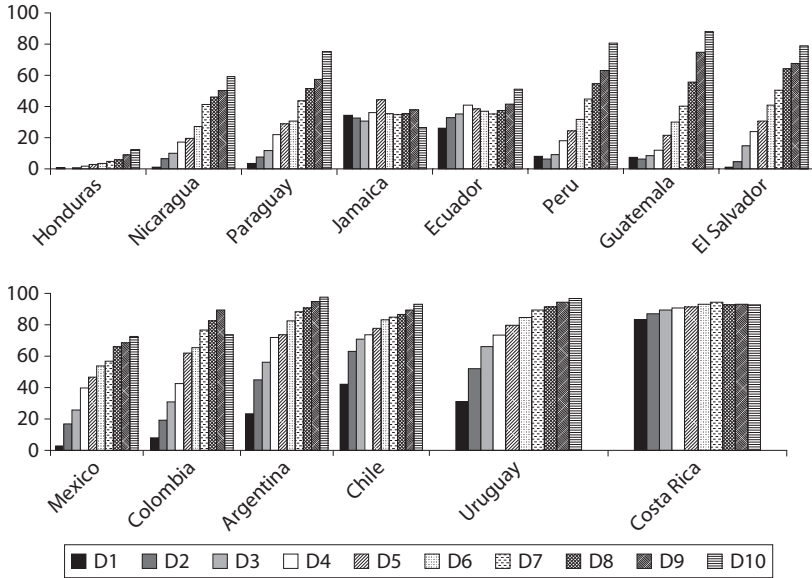
**Figure 1.3 Contributory Health Insurance Coverage in LAC, Mid-2000s**  
(percentage of the population covered)



*Source:* World Bank staff calculations based on household survey data, most recent available year.

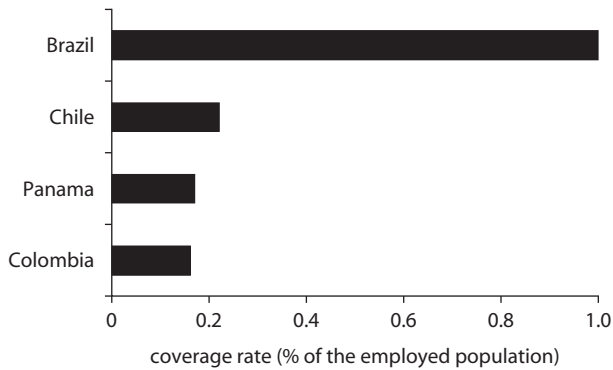
*Note:* A household is classified as insured if at least one household member is covered by contributory health insurance.

**Figure 1.4 Contributory Health Insurance Coverage in LAC, Mid-2000s, by Decile of per Capita Income**  
(percent of population covered)



Source: World Bank estimates based on household survey data, most recent available year.  
Note: A household is classified as insured if at least one household member has contributory health insurance.

**Figure 1.5 Unemployment Insurance Savings Accounts per Employed Worker**



Source: Ferrer and Riddell 2008.  
Note: 1 = 100 percent.

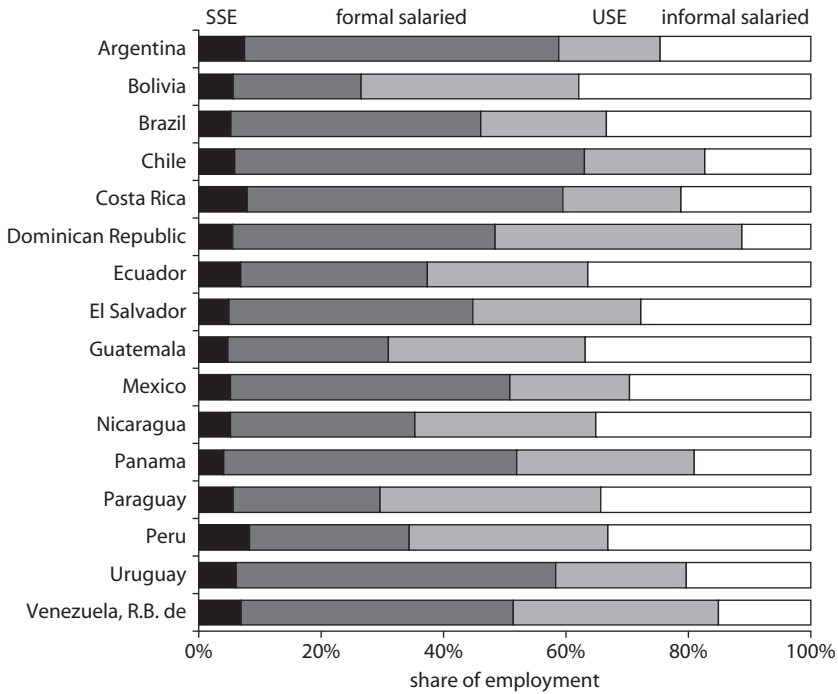
made by workers and their employers. Policy makers assumed that, as the region's economies developed, the majority of the labor force would come to be working in formal salaried jobs so that SI contributions could be enforced. However, a sizable share of the labor force continues to work in the informal and agricultural sector, in which it is difficult to enforce social security. It was overly optimistic to expect that productivity in small and medium-size enterprises, which are important sources of jobs, would always be high enough to cover the costs of social security contributions. To make matters worse, the region's SI systems failed to incorporate incentives to comply with regulations (including paying taxes). Poor governance, regulatory uncertainty, and corruption have reduced the expected benefits from formality for the workforce and thus have encouraged the evasion of social security.

In the twenty-first century, more than half of LAC's workforce is employed in the informal sector and is not covered by social security. In many countries, far from declining, informality has risen in recent decades. The lowest level of informality is in Chile at around 40 percent, and the highest is in Bolivia at close to 75 percent (see figure 1.6). The situation is further complicated by the fact that, for any worker, informality is not necessarily a stable state. Many move in and out of the informal sector (and the social security system) multiple times throughout their working lives. In Argentina, Chile, and Uruguay, for instance, the median worker spends only half of his or her working life contributing to social security (see table 1.1). For low-income workers and young people, pension contribution densities are generally less than 40 percent, and the turnover of SI membership is correspondingly higher.<sup>2</sup>

In response to the problem of the low coverage of contributory SI, many LAC governments have introduced noncontributory pensions and health insurance systems.<sup>3</sup> These systems have been important means of closing the coverage gap and extending access to low-income individuals and the poor (see figures 1.7 and 1.8). Generally, however, these programs are not well integrated with contributory programs and have problems of financial sustainability and incentives, which are discussed in Challenge III.

In the case of health, noncontributory programs vary greatly in design, with differences in target populations, benefits, and administrative arrangements. Two major types can be distinguished: (1) targeted schemes with benefits that are comprehensive but inferior to those of contributory SHI; and (2) schemes with limited benefits for health priority groups (such as mothers and children). They are administered by the

**Figure 1.6 The Share of the Formal and Informal Sectors in LAC Labor Markets**



Source: World Bank calculations based on statistics from SEDLAC.

Note: SSE = skilled self-employed; USE = unskilled self-employed. Informal salaried refers to salaried workers in small firms. The informal sector includes these salaried workers and the unskilled self-employed.

NHS (providing additional subsidy for some users of NHS systems,<sup>4</sup> for example, Mexico), by the SHI (creating a noncontributory window for people in the informal sector, for example, Colombia), or by independent insurance agencies (for example, Chile and the Dominican Republic).

### **Challenge II: LAC’s Social Insurance Systems are Fragmented and Uncoordinated**

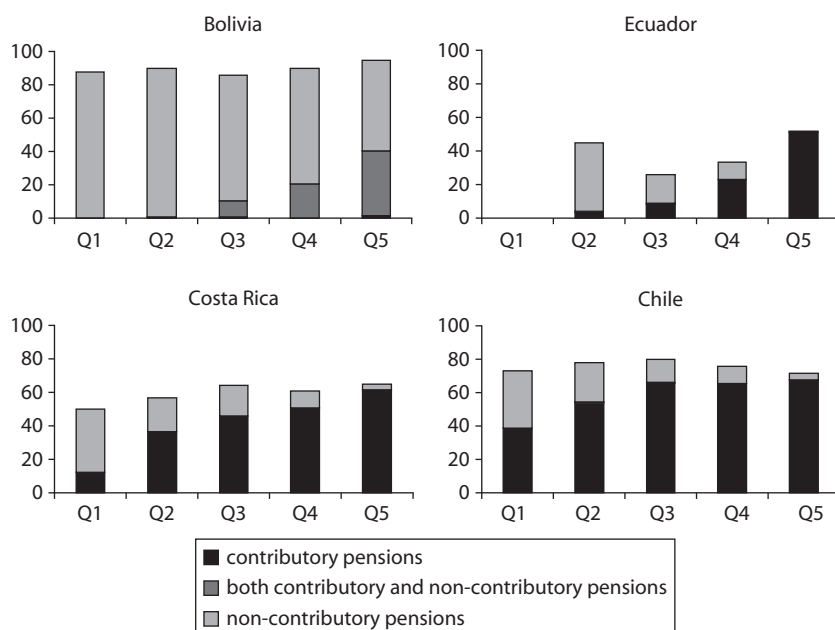
In addition to having continuing low overall coverage rates, LAC’s contributory SI systems have evolved in an ad hoc manner, often producing multiple programs and institutions with unclear mandates regarding their benefits and beneficiaries. In many cases, it is not clear how the system’s parameters, rules, and benefit entitlements are related. Many countries have multiple income protection (UI), pensions, and health

**Table 1.1 Contribution Densities in Argentina, Chile, and Uruguay**

	Argentina		Chile		Uruguay	
	Mean	Median	Mean	Median	Mean	Median
<b>Total</b>	55	56.7	47.2	47.4	58.4	61
<b>Sex</b>						
Men	56.9	61.2	53	55.4	59.6	63
Women	55	55.6	39.7	35.7	57	58.1
<b>Income bracket</b>						
Poorest quintile	44.1	36.9	28.6	21.9	42.9	31.4
2nd quintile	51.4	48	43	40.9	55.9	54.8
3rd quintile	54.5	54.5	48.7	50.3	60.3	62.9
4th quintile	58.6	65.6	56.4	59.7	64.4	71.4
Richest quintile	67.7	88.9	60.5	65.6	68.5	85.7
<b>Age</b>						
20	34.7	20	44.9	45.1	49	47.6
35	69.2	83.3	51.9	54.2	69.6	86.7
50	68	85	42.3	48.6	71.6	92.4

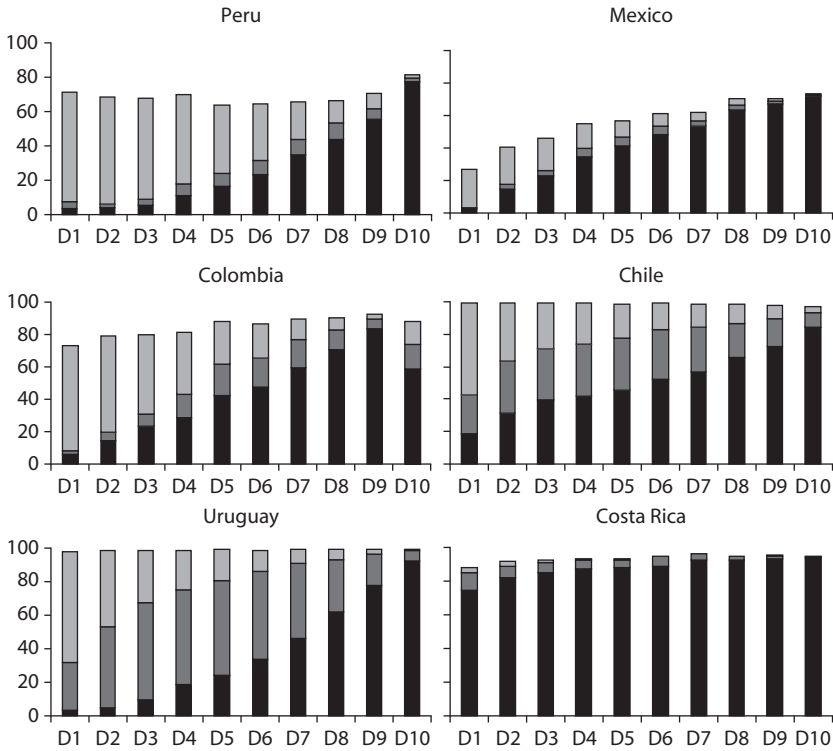
Source: Forteza, Lucchetti, and Pallares 2009.

**Figure 1.7 Contributory and Noncontributory Pension Coverage among the Elderly by Income Quintiles and Source in the 2000s**  
(percentage of population over the age of 65)



Source: World Bank staff calculations adapted from Rofman, Lucchetti, and Ourens 2008.

**Figure 1.8 Contributory, Noncontributory, and Combined Health Insurance Coverage in the Mid-2000s by Income Quintiles and Source**  
(percentage of population covered)



*Source:* World Bank staff estimates based on household survey data, most recent available year.  
*Note:* A person is classified as insured if at least one member of the household is covered by contributory, non-contributory, or both contributory and noncontributory health insurance. All data are from 2006.

insurance systems operating in parallel, often with no coordination. For example, eight countries have fragmented income protection systems. Nine countries have fully integrated pensions systems and four have partially integrated systems, but four countries still have multiple, uncoordinated systems (Brazil, Mexico, Paraguay, and Peru). As discussed below, fragmentation is especially common in the case of health systems, as within mainland Latin America, only Brazil and Costa Rica have integrated systems, whereas all other countries have two or more separate systems (table 1.2).<sup>5</sup>

The region has a large variation in the benefits offered by SI programs. For instance, in pensions, replacement rates for the average worker range

**Table 1.2 Institutional Integration of LAC's SI Systems**

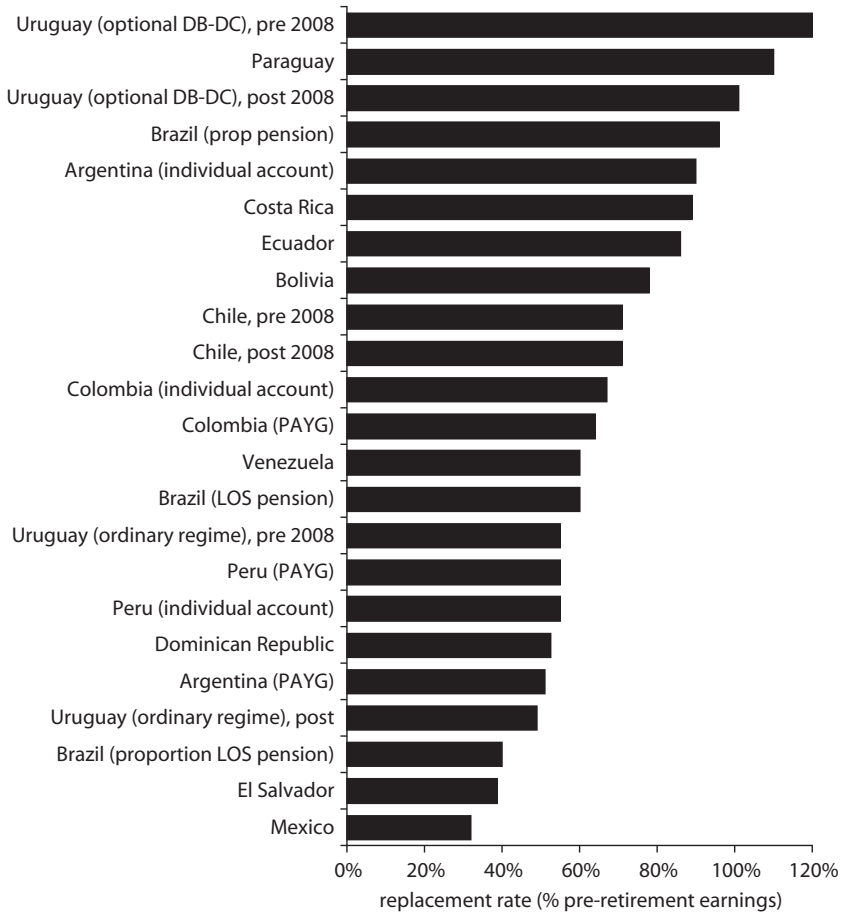
	<i>Income protection</i>	<i>Pensions</i>	<i>Health</i>
Argentina	No	Partly	No
Bolivia	Yes	Yes	No
Brazil	Yes	No	Yes
Chile	No	Yes	No
Colombia	No	Partly	No
Costa Rica	–	Partly	Yes
Dominican Republic	–	–	No
Ecuador	No	Yes	No
El Salvador	Yes	Yes	No
Guatemala	Yes	Partly	No
Honduras	Yes	Yes	No
Mexico	Yes	No	No
Nicaragua	Yes	Yes	No
Panama	No	Yes	No
Paraguay	Yes	No	No
Peru	No	No	No
Uruguay	No	Yes	No
Venezuela, R.B. de	No	Yes	No

*Source:* World Bank, based on country data.

*Note:* The table indicates whether the social insurance systems within each of the three sectors are integrated. *Yes* means the sector has only one system, *no* means the sector has more than one system, and *partly* means the sector has more than one system, but the systems are partially integrated.

from 120 percent in Uruguay to as low as 33 percent in Mexico (see figure 1.9). Similarly, unemployment benefits can be claimed for as short a time as two weeks in Paraguay to more than nine months in Argentina. It is not surprising that differences between countries' social preferences and economic and political conditions should lead to differences in SI mandates. However, the observed variations do not necessarily reflect deliberate choices made by policy makers about the objectives of the programs. Rather, the pattern of benefits and contributions tends to be the cumulative result of ad hoc decisions made throughout the history of the program in response to specific problems, such as the need for financial sustainability, or to political demands to increase benefits. Moreover, as can be seen in figures 1.9 and 1.10, large variations exist among SI schemes within the same country. For instance, schemes for civil servants and the military normally are more generous than schemes for private sector workers.

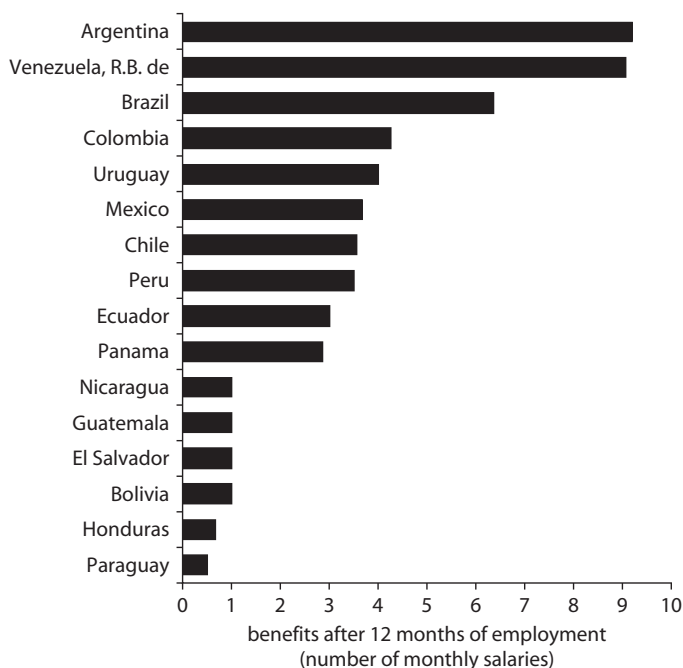
In the case of health, the region's governments have addressed challenges in different ways, and as a result, LAC has a complex legacy of systems and subsystems. LAC has two basic configurations of publicly

**Figure 1.9 Mandates of Pension Systems (average worker)**

*Source:* Based on Forteza and Ourens 2009.

*Note:* DB = defined benefit; DC = defined contribution; LOS = Length of Service; PAYG = pay-as-you-go. Calculations are adjusted to make mandates comparable across countries.

mandated systems for health SP: (1) *Stand-alone NHS systems*, which are funded from general taxation and provide both financial protection and health services to the population at large (in Brazil and several Caribbean countries); and (2) *SHI systems combined with NHS*. SHI systems are funded from payroll taxes and user contributions. They often operate separate schemes for employees in the public and private sector and combine health insurance with other forms of SI, such as pension systems (for example, in Ecuador, Honduras, and Mexico). In some countries, the SHI or NHS systems operate additional targeted noncontributory programs.

**Figure 1.10 Mandates of Unemployment Benefit Systems (average worker)**

Source: World Bank staff calculations based on national data sets.

This fragmentation of LAC's health systems is reflected in differentiated mandates, revenue collection arrangements (payroll taxes and user contributions versus general revenues) and (often) separate provider networks. Two-tier health systems provide different coverage for the users of contributory and noncontributory systems (SHI and NHS). Due to budgetary constraints, the mandate (service bundle) of noncontributory systems is limited, with emphasis normally placed on primary and secondary care. Because of decades of underinvestment in delivery systems and regulatory problems, service quality tends to remain low. In general, health financing and service production remain integrated. Health ministries that administer the budget run NHS systems and, as a general rule, operate the hospitals and clinics.<sup>6</sup> The budget is transferred, almost as an entitlement, to providers, to cover the salaries and benefits of their employees, with no link to results, productivity, or quality. Similarly, most SHI systems combine insurance and service production. As a result, NHS and SHI provider networks operate in parallel, duplicating service delivery infrastructure. The absence of links between financing and productivity or quality and the

duplication of service delivery infrastructure both have negative implications for efficiency.

The heterogeneity of the plans and mandates of LAC's SI programs is inequitable and inefficient. It is inequitable because workers are treated differently by the public system depending on where they work. It is inefficient for four reasons. First, multiple systems fragment the labor market and constrain labor mobility. In Ecuador and Uruguay, for instance, workers who switch jobs can lose their pension rights. This reduces their incentives to move between jobs and can negatively affect labor productivity growth. Second, fragmentation makes insurance risk pools smaller and raises the costs associated with reserve requirements. Third, administrative costs can increase because having multiple systems reduces economies of scale (because a large share of administrative costs is fixed). Fourth, in the case of health, mutual exclusivity across health programs and a lack of consumer choice among programs and care providers leads to significant inefficiencies in the production of health care (for example, low use of capacity in health facilities and suboptimal allocation of care) and may lead to distortions in the labor market (since job choice can be influenced by nonportable benefits). The Mexican health system is a classic example.

A related problem is the lack of coordination in the design of different types of SI programs, and among social assistance and labor market programs and policies, which diminishes the overall coherence of the SP system. Old-age income support, health, and antipoverty reforms have been implemented in a piecemeal way, with policy makers giving little attention to the interactions among these reforms. Few countries coordinate ALMPs with income protection programs. Similarly, policies on disability pensions are seldom coordinated with policies on unemployment benefits. This lack of coordination can be seen in Chile and Argentina, where disability benefits sometimes substitute for unemployment benefits. Better coordination would lower costs (helping to reduce the level of social security contributions needed for a given level of coverage), improve incentives (resulting in less fraud and evasion), and lead to better outcomes.

### **Challenge III: Redistribution within the Social Insurance Systems is Opaque, Often Regressive, and Can Distort Incentives to Work and Save**

SI coverage for low-income people in LAC is limited. For the extreme poor, enrolling in full-cost contributory SI programs is difficult and often impossible. Even the moderately poor—who do have some savings

capacity—usually are excluded from these programs because many work in small firms where productivity is too low to cover the full cost of mandatory SI. In addition, these people often have relatively high personal discount rates and preferences for liquidity and a correspondingly low demand for long-term savings and insurance.

LAC's policy makers have introduced two types of intervention to extend the reach of SP systems to low-income workers. The first type consists of pure antipoverty programs, which we will discuss in the following section (Challenge IV). The second type, discussed in this section, consists of subsidies to SI.

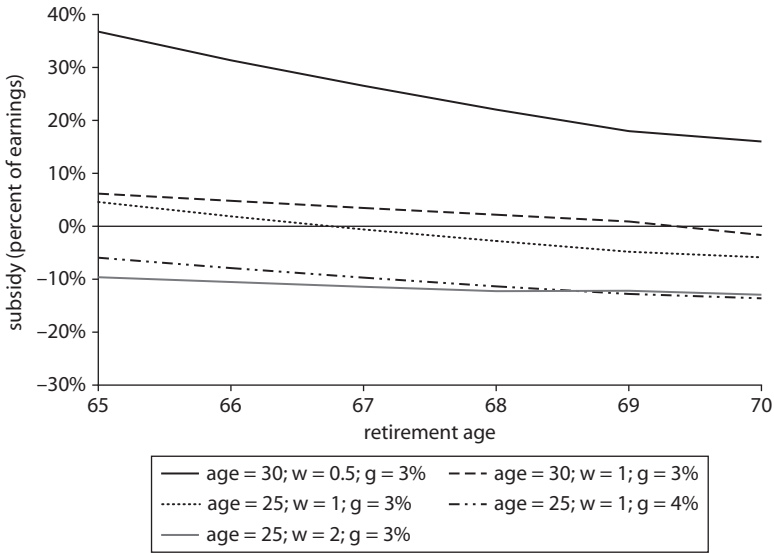
The two kinds of SI subsidies are (1) implicit subsidies to some plan members within the contributory systems, which generally are financed through payroll taxes and social security contributions levied on other plan members, and (2) explicit subsidies to noncontributory pensions, unemployment, or health insurance programs, which usually are financed out of general tax revenues. In terms of redistribution, the first type of subsidy is often regressive, whereas the second is in most cases progressive. If they are not designed carefully, both can have negative incentive effects on labor supply and savings and reduce participation in contributory SI.

### ***Implicit and Nontransparent Subsidies and Taxes***

LAC's contributory SI systems are plagued by implicit and nontransparent subsidies and taxes. Complex cross-subsidies within programs result in wide variations in the ratio of contributions paid to benefits received. Some plan members systematically receive more than they put in (a subsidy), while others systematically receive less (a tax).<sup>7</sup> Figure 1.11 illustrates this using the case of the pension system in Brazil. Depending on earnings and on when individuals enroll and retire, they receive a subsidy or pay a tax to the system—and the level of both the tax and the subsidy can be high.

Figure 1.11 illustrates the considerable variation in the level of subsidy (tax) received (paid) depending on when individuals enroll and when they retire and their level of earnings. In the Brazil example illustrated here, the formal rules suggest that low-income workers will receive implicit subsidies, as do those who delay enrollment or whose wages grow more slowly. But when all such effects are combined, the most common outcome across the region is to have implicit taxes or subsidies that are regressive. This happens in part because high-income workers are more likely to remain in the system long enough to qualify

**Figure 1.11 Implicit Taxes and Subsidies in the Brazilian Pension System**



*Source:* Authors' calculations.

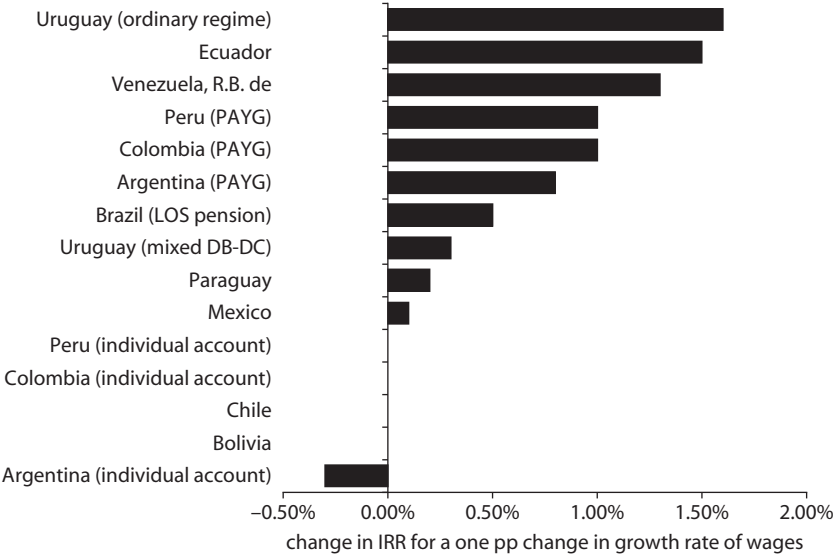
*Note:* Each line gives the value of the expected subsidy (or tax) as a function of the retirement age. The subsidy or tax is expressed as a percentage of the worker's salary. Each line is associated with a given age of enrollment, a given entry wage  $w$  (expressed as a proportion of average earnings), and a growth rate for this wage.

for benefits. In contrast, low-paid workers tend to experience more job instability and they are less likely to complete the vesting periods required to become entitled to benefits (see Forteza, Lucchetti, and Pallares 2009). In the case of pensions, defined benefit formulas tend to pay higher rates of return to workers with steep wage histories (usually skilled workers) than to those with flat wage histories (usually blue-collar, unskilled workers) (see figure 1.12).

Similarly, many health insurance systems base users' contributions on their incomes, rather than the cost of the package of health services. In many cases, this is likely to induce transfers from richer to poorer insured workers. It is also possible that young low-risk low-income individuals subsidize the coverage of high-risk high-income individuals. Such rules can undermine the insurer's incentives to expand coverage to low-income workers, because their contributions would not cover their costs. To the extent that low-income workers are outside the system, the hoped-for progressive redistribution fails to materialize.

Regressive redistribution can take place between plan members and other individuals who currently are not covered by the SI system, including

**Figure 1.12 Changes in Rates of Return on Contributions for Pension Resulting from a One Percentage Point Increase in the Growth Rate of Wages during a Working Life**



*Source:* Based on Forteza and Ourens 2009.  
*Note:* DB = defined benefit; DC = defined contribution; IRR = internal rate of return; PAYG = pay-as-you-go.

future generations. In many LAC SI systems, the imbalance between contributions and benefits generates large, system-wide cash flow deficits that must be covered by fiscal transfers. A recent study of eight LAC SI systems found an average annual subsidy of PPP \$62 per person (Lindert, Skoufias, and Shapiro 2006). The estimated subsidies (as a percentage of total benefits transferred and taking into account only the costs of current deficits in the SI system) were as follows: Argentina (57 percent), Brazil (40 percent), Chile (56 percent), Colombia (77 percent), the Dominican Republic (0 percent), Guatemala (25 percent), Mexico (84 percent), and Peru (89 percent).<sup>8</sup> (See table 1.3.) Because the beneficiaries of most SI systems are toward the top of the income distribution, fiscal subsidies to cover such deficits are regressive. The same report used household survey data to analyze the distribution of these subsidies and confirmed that their incidence is highly regressive. On average, 58 percent of SI subsidies benefit those in the top quintile of the income distribution, whereas only 3 percent benefit those in the bottom quintile. In contrast, noncontributory social assistance channels 26 percent of benefits to those in the

**Table 1.3 Distribution of Subsidies to Social Insurance and Social Assistance in LAC**

Country	Social insurance <sup>a</sup>					Social assistance				
	Average unit benefit	Benefit incidence <sup>a</sup> (%)		Impact on income <sup>c</sup> (%)		Average unit benefit (%)	Benefit incidence <sup>b</sup> (%)		Impact on income <sup>c</sup> (%)	
		Q1	Q5	Q1	Q5		Q1	Q5	Q1	Q5
Colombia	23.7	1.0	66.0	0.1	0.6	35.9	32.0	1.0	35.9	0.1
Mexico	65.6	3.0	63.0	0.8	0.4	9.6	20.0	31.0	3.3	0.1
Guatemala	20.7	1.0	81.0	0.1	0.7	9.3	13.0	22.0	7.9	1.5
Argentina	106.1	1.0	56.0	3.4	9.0	35.9	32.0	1.0	35.9	0.1
Chile	80.9	4.0	46.0	4.2	4.0	11.9	28.0	10.0	8.8	0.3
Brazil	52.9	5.0	54.0	6.9	4.3	6.7	38.0	12.0	2.4	0.0
Peru	100.1	1.0	68.0	0.7	6.6	1.6	30.0	6.0	1.9	0.1
Dom. Rep.	46.1	7.0	30.0	0.3	0.1	n/a	14.0	28.0	7.1	0.9
<b>Average<sup>d</sup></b>	<b>62.0</b>	<b>2.9</b>	<b>58.0</b>	<b>2.1</b>	<b>3.2</b>	<b>15.8</b>	<b>25.9</b>	<b>13.9</b>	<b>12.9</b>	<b>0.4</b>

*Source:* Derived from Lindert, Skoufias, and Shapiro 2006, Table 4a, page 64.

*Note:* a. The subsidy share of social insurance is defined as the proportion of total cash-flow expenditure of SI that is funded from taxation rather than from members' contributions or interest income to the insurance funds. This study did not attempt to calculate actuarial deficits.

b. The proportion of the total benefit that is received by households in the bottom quintile (Q1) and top quintile (Q5).

c. The relative impact of the benefit received on household income in Q1 and Q5 respectively.

d. Unweighted average for the eight countries.

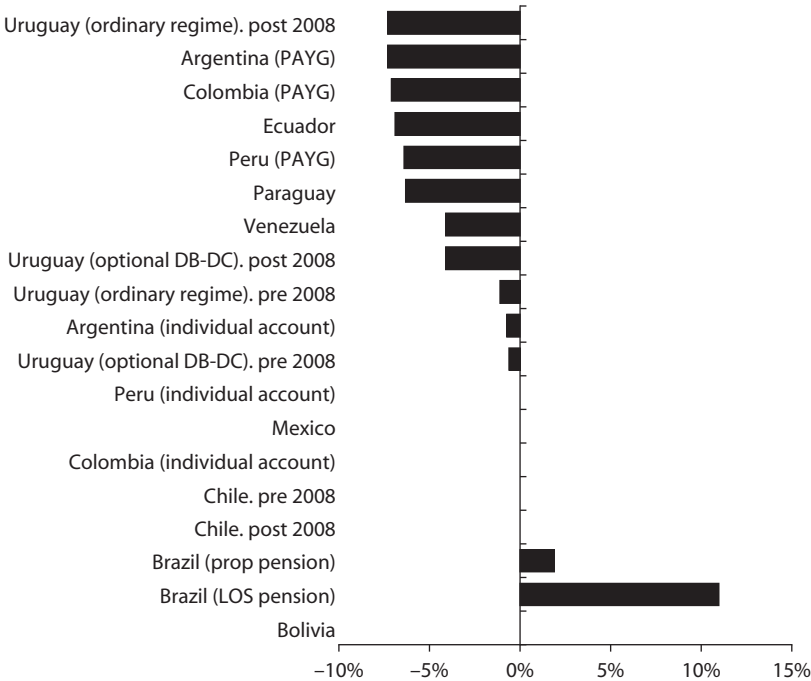
bottom quintile and only 14 percent to those in the top quintile. Although the value of the average benefit from social assistance is only a quarter of that from insurance programs, it has a much bigger relative impact on the incomes of poor households, increasing incomes of beneficiaries in the bottom quintile by 13 percent, on average, compared with 2 percent for SI (Lindert, Skoufias, and Shapiro 2006).

The numbers in table 1.3 take into account only the cost of current deficits in the SI system. The situation would be even worse if the actuarial deficits of pay-as-you-go and UI systems were taken into account. One way to measure the size of this problem is to estimate the liabilities of the system (in other words, the present value of future pension payments resulting from acquired rights to date) and compare them with the so-called pay-as-you-go asset (the present value of future revenues from contributions, net of the additional pension rights that will accrue from them under present rules). In several LAC countries, the resulting difference (the so-called unfunded liabilities of the system) runs in excess of 100 percent of gross domestic product (GDP) (Holzmann, Palacios, and Zevine 2004).

Implicit taxes and subsidies also affect individuals' labor market behavior. For example, under existing rules, the ratio of pension entitlements to contributions can be affected by the timing of workers' enrollment and retirement, by their career histories, and by the frequency (density) of their contributions. The rules of most pension systems in LAC penalize workers who choose to retire later by giving them lower rates of return, thus creating an incentive to retire early (see figure 1.13). Pension benefit rules based on final salaries reward income growth in the last years of work with higher rates of return, creating incentives for workers to negotiate large salary rises close to retirement. Similarly, the amount of subsidy that workers receive from UI often depends on the frequency and duration of their periods of unemployment.

Both forms of financing of the implicit redistribution in contributory systems (payroll taxes levied on employers, and the tax element in employee contributions that surpass benefit values) have the additional

**Figure 1.13 Impact on Rate of Return on Contributions of Increasing the Retirement Age from 65 to 70**



Source: Based on Forteza and Ourens 2009.

drawback that they increase the tax wedge.<sup>9</sup> Considerable international evidence indicates that this can reduce employment levels and promote informality. In the ECA region, a 10 percentage point increase in the tax wedge is estimated to have led to a reduction of between 3 and 6 percentage points in the employment-to-population ratio (Rutkowski 2007). A recent study of Turkey found that the pass-through of social security contributions to wages is low for low-income workers, so increased contributions lead directly to increased total wage costs and to reduced employment (Betcherman, Daysal, and Pagés 2008). Colombia experienced a rise in payroll taxes of more than 10 percentage points (from 41 to 51.5 percent) between 1989 and 1996, which is estimated to have caused a decline in formal employment of 4 to 5 percent (Kugler and Kugler 2003).

Financing SI benefits by mandatory contributions from workers and their employers is justified by the fact that, in the absence of a legal mandate, many workers might save and insure themselves too little, thus creating the negative externality of the need for publicly funded safety nets. However, when *additional* contributions are levied to finance redistribution (in other words, to pay for other peoples' benefits), these contributions increase the tax wedge for the workers who pay them and are likely to have a negative effect on formal employment. Alternative options for funding the solidarity element of the SP system are discussed in chapter 3.<sup>10</sup>

### ***Explicitly Subsidized Noncontributory Programs***

As discussed under Challenge II, many countries have established non-contributory SI programs funded from general taxation for workers in the rural or urban informal sectors. These programs have closed the coverage gap but have caused problems of their own, particularly when the benefits that they offer are reduced when a worker receives benefits from a contributory program. Noncontributory programs often are designed under the assumption that workers are employed either completely in the formal sector (and thus covered by social security) or completely outside it (thus needing to be covered by noncontributory programs). As discussed, however, many individuals move in and out of the social security system during their working lives, sometimes as a result of their preferences (see Perry et al. 2007).

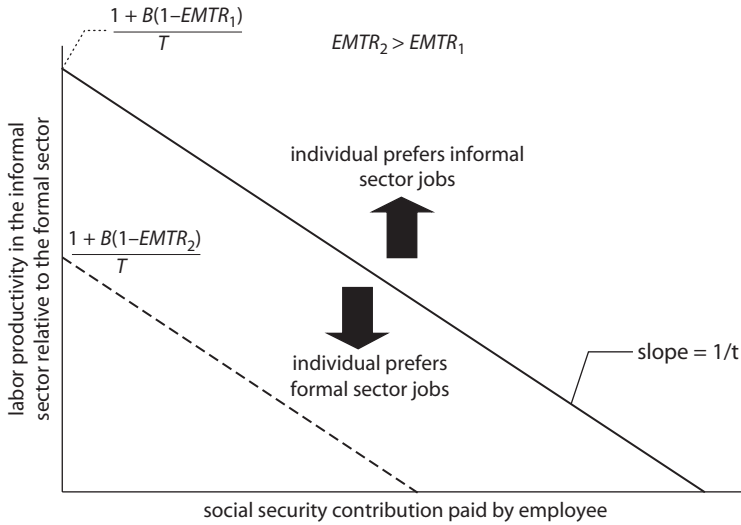
Whenever workers that take formal sector jobs lose the benefit of a noncontributory transfer, the lost benefits act as an implicit tax on formal sector work. Similarly, if noncontributory benefits are reduced when a person receives contributory benefits, this increases the effective marginal

tax rate (EMTR) on formal sector earnings. The minimum pension guarantee in Brazil and the minimum pension in Chile (before the 2008 reform) illustrate this point. In each case, the amount of subsidy depends (inversely) on the value of the contributory pension to which the person is entitled. The EMTR is 100 percent: For each unit increase in the contributory pension, the minimum pension transfer is reduced by one unit. As a result, low-income workers find that contributing more does not increase their total pension.<sup>11</sup>

A high EMTR can reduce contribution densities by increasing the amount of time that individuals spend in the informal sector. The outcome in terms of additional informality will depend on the relative productivity of the formal and informal sectors. If productivity (and, therefore, wages) in the formal sector are much higher than those in the informal sector, even high social security contributions and high EMTRs on transfers will not lead many people to prefer informal sector jobs, because net earnings in the formal sector would still be higher. If, however, the difference in productivity (and wages) were too small to offset the cost of social security contributions and the EMTRs on transfers, then workers might prefer jobs in the informal sector. The more generous a program, the more likely it is to affect workers' behavior. This idea is illustrated in figure 1.14.

In the case of noncontributory health insurance programs the evidence for negative effects on informal work is weak. In 2010, Mexico's subsidized health regime, *Seguro Popular*, offers net benefits<sup>12</sup> that are higher than those of the formal health insurance regime operated by the Mexican social security institute, the IMSS, so it might be expected to increase the likelihood that individuals will take informal sector jobs and reduce IMSS affiliation. The available studies, however, find no statistically significant decrease in affiliations to IMSS health insurance in urban areas as a result of the *Seguro Popular*. In rural areas, IMSS coverage has been only slightly reduced (from 14 percent to 11.2 percent). Overall it is estimated that nationwide the displacement effect of *Seguro Popular* reduced IMSS coverage by only 0.7 percent of the population. This must be set against the increase of 7.1 percent coverage provided by *Seguro Popular*, giving an overall net gain in coverage of 6.4 percent of the population (Parker and Scott 2008). In Colombia, some employers reportedly have begun to require workers to obtain health insurance through the noncontributory scheme before they will hire them (CIDE 2007). Overall, the evidence base for understanding this sort of interaction effect in LAC remains limited and further research is needed.

**Figure 1.14 The Impact on Choice of Informality and Increase in the Effective Marginal Tax Rate on Formal Wages**



Source: Authors.

Note: EMTR = effective marginal tax rate. The slope of the line depends on the employer’s payroll tax ( $t$ ), which affects the total cost of labor in the formal sector, here assumed to be equal to labor productivity. The intercept of the lines with the y axis depend on the employee contribution rate, the value of the transfer ( $B$ ), and the EMTR. Along the lines, the differences in labor productivity between the formal and informal sectors are equal to the tax wedge. Along the dotted line, the EMTR is higher than on the solid line.

These issues are relevant because available evidence suggests that informality involves significant economic costs. Informal production units tend to have low productivity because they are unable to benefit from economies of scale and have difficulty accessing both markets and credit. Therefore, any policy that creates incentives to informality may undermine growth. Levy (2008) has argued that the recent development of Mexico’s SP system unintentionally has promoted the growth of small-scale, informal firms, which are intrinsically uncompetitive and whose growth potential is limited.

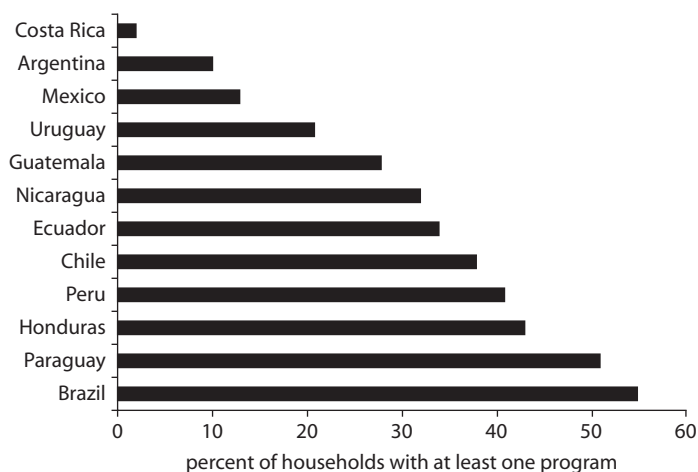
Redistribution arrangements and economic incentives are two sides of the same coin. Badly designed redistributive arrangements are not only likely to be regressive but can also change workers’ and firms’ behavior, reducing formal sector employment and increasing program costs. The less transparent a redistribution system, the more prone it is to gaming, fraud, and abuse.

### Challenge IV: Enhancing the Effectiveness and Human Capital Impact of Income Support Programs

Large-scale poverty-targeted income support programs, which provide a minimum income floor for the extreme poor, are now a significant part of the SP architecture in LAC (see figure 1.15). Eligibility for these programs normally is based on poverty levels, using geographic targeting, household means-testing, or self-selection. Targeted transfers have gradually replaced untargeted consumption subsidies (for example, on food or fuel). For example, in Mexico, *Progresa* (now *Oportunidades*) replaced subsidies on maize. Income support includes both cash and in-kind (food-based) programs, but cash-based programs are increasingly prevalent and have tended to replace in-kind transfers.

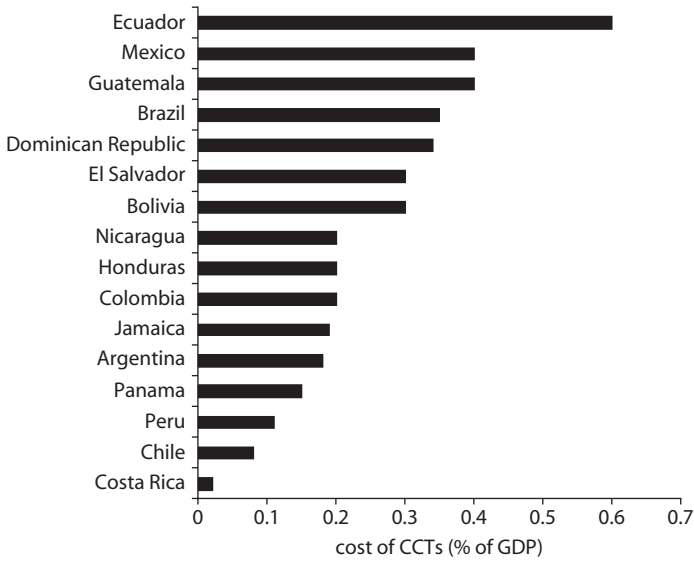
The main types of cash transfer in LAC are as follows: CCTs, workfare programs, and unconditional cash transfers targeted on specific groups (such as families, children, or older people). CCTs exist in 16 LAC countries, with budgets ranging from 0.1 percent of GDP in Chile and Peru to 0.6 percent of GDP in Ecuador (see figure 1.16). In many countries, including Argentina, Bolivia, Colombia, Mexico, Peru, and Uruguay, *workfare programs* have been implemented—often in crisis situations—with the goal of ameliorating the effects of unemployment. The main targeting mechanism in this case is the self-selection of those willing to work for the offered wage,

**Figure 1.15 Coverage of Income Transfer Programs in LAC**



Source: World Bank staff calculations.

Note: Includes cash and food-based programs.

**Figure 1.16 Cost of CCT Programs in LAC**

Source: World Bank staff estimates based on country data.

but many have additional qualifying rules. For example, beneficiaries of Argentina's *Jefes* workfare program must have dependents, for Colombia's *Empleo en Acción*, they must be qualified as poor by a proxy means-test, and in Mexico's *Programa de Empleo Temporal (PET)* they must live in a poor rural area. Another emerging model—especially prevalent in the southern cone—is **unconditional cash transfers** targeted on poverty and demographic status such as child benefits, disability pensions, and family allowances. One example is the *Asignación Familiar* family allowance system introduced as part of Uruguay's *Plan de Equidad*, which grew out of the *Plan de Atención Nacional a la Emergencia Social (PANES)* program. Other examples include the old-age and disability pension, *Beneficio de Prestación Coninuada (BPC)* in Brazil, the Universal Child Allowance in Argentina, and the Family Subsidy (*Subsidio Único Familiar*) in Chile.

LAC's income transfer programs cannot always be placed neatly into one of these categories, and some countries are developing new models. For instance, PANES in Uruguay combined its *Ingreso Ciudadano* (citizen's income) program for extremely poor households with a workfare component called *Trabajo por Uruguay*. The *Jefes* workfare program in Argentina evolved into an employment benefit and training program, called *Seguro de*

*Capacitación y Empleo*, and a CCT Program called *Familias*, which is now being replaced by poverty-targeted family allowances.

Now that income support programs have been consolidated as an important element of LAC's SP system, several issues need to be addressed to improve the future impact of targeted income support programs. This section highlights four pending challenges for this class of SP programs: reinforcing targeting; ensuring the quality of complementary health and education programs; improving crisis response capacity; and avoiding perverse labor market incentive effects.

### **Reinforcing Targeting**

The targeting and poverty reduction outcomes of LAC's income transfer programs are positive, but they also are uneven and urban expansion might dilute them. Over the last decade, Gini trends in LAC have begun to improve, and income transfer programs such as CCTs have played an important part in the turnaround (Ferreira, Leite, and Ravallion 2009; Lopez-Calva and Lustig 2010; Paes de Barros, Foguel, and Ulyssea 2006). In many cases, significant gains have been produced at a modest fiscal cost. CCTs account on average for 0.25 percent of GDP, cover 16.9 percent of the population, and spend the equivalent of 3.1 percent of average per capita income per beneficiary household. Although they are not expensive, tight targeting on the extreme poor means that most CCTs are able to provide relatively generous benefits, compared with pretransfer income. As a result, their impact on the spending capacity and poverty level of beneficiaries is significant. *Oportunidades* in Mexico has reduced the poverty gap by 19 percent. In Brazil, *Bolsa Família* has reduced the poverty gap by 10 percent.<sup>13</sup> In Ecuador, the reduction has been 14 percent (Fiszbein and Schady 2009).

But not all cash transfer programs have such a clear and cost-effective impact on poverty. Evaluation evidence suggests that the targeting of many workfare programs has not been strong—especially compared with CCT programs. Workfare programs normally reach around 2 percent of the economically active population (EAP), so their distributional impact is necessarily limited. Their benefit amounts generally are much larger than CCTs. For example, *Construyendo Peru* has a benefit of \$153 a month, which is 10 times the benefit of \$15 a month of the Peruvian CCT program *Juntos*. This makes workfare an expensive option and also makes the programs attractive to less-poor workers. Most countries limit spending on workfare to around 0.2 percent of GDP. Exceptions are *Jefes* in Argentina, which had a modest benefit of \$45 a

month and 2 million beneficiaries, reaching 13 percent of the EAP at a cost of 0.8 percent of GDP during the peak of the economic crisis; and PANES in Uruguay, which reached 7.2 percent of the population at a cost of 0.5 percent of GDP.

Whichever program type is chosen to channel income support to the poorest families, maintaining tight targeting will be a continuing challenge. Pressure is growing to further expand these programs into urban areas, where a large proportion of the region's poor and extremely poor households now reside. Among the major CCT programs that recently have expanded urban coverage are *Bolsa Família* (Brazil), *Familias en Acción* (Colombia), and *Oportunidades* (Mexico). The considerable variations in poverty among households in urban marginal areas, coupled with political economy factors, can make it difficult to target effectively in urban areas. This calls for strengthening governance arrangements through the definition of clear eligibility rules, robust beneficiary registers, and transparent financial administration. Another interesting approach to strengthening targeting is to use survey-based estimates of poverty levels to "shadow" the distribution of claimants that arises from the system, as is done by *Bolsa Família* in Brazil.

CCTs and similar programs need to improve procedures for enrolling and graduating beneficiaries in a timely fashion. This will encourage the exit of families who are no longer poor, and open space to incorporate new beneficiaries. In early 2010, Brazil's *Bolsa Família* removed 6 percent of beneficiaries who had not updated their registers, opening the way to incorporate families who qualified for the program more recently. CCTs need to ensure that the practice of verifying conditionalities (or coresponsibilities) is adapted to urban settings.

### ***Ensuring the Quality of Complementary Health and Education Programs***

Poor-quality health, nutrition, and education services often limit the human development impacts of CCTs. Income support programs have the potential to increase beneficiaries' long-term earnings capacity by increasing the human capital accumulation through income effects and (in the case of CCTs) through the nutrition, health, and education conditionality attached to program membership. Evaluations show that CCTs in LAC have increased school enrollment and attendance rates and reduced school dropout rates (Behrman, Sengupta, and Todd 2000; Britto 2004, 2007; Rawlings 2005). They have increased the take-up of vaccinations and visits

to health centers for growth and development consultations (Bouillon and Tejerina 2006; Britto 2007; Rawlings 2005).

Thus far, however, CCTs have produced only modest improvements in education, health, and nutrition *outcomes*. This indicates that ensuring attendance, alone, is not enough. Governments also need to improve the quality of health and education services, which in many places remain deficient, and to ensure access to these services. Poor quality, linked to inadequate funding and weak accountability systems, is a problem in both poor rural and marginal urban areas.

Ensuring access of the poorest families to all the programs to which they are entitled, with good quality, is emerging as a major challenge for social policy in LAC. The region has many remote rural communities without decent physical access to health services—and fast-growing urban settings often have a problem of overstretched capacity. Tackling such issues will require stronger liaison between cash transfer programs and the health and education authorities.

Colombia's *Juntos* program and Chile's *Chile Solidario* are developing interesting models to build beyond cash transfers to strengthen overall SP for the most vulnerable. This approach implies a complex pattern of cross-sectoral management, which requires the following: (1) identification of all available benefits in the SP network, (2) formal agreements between the institutions involved to provide services to the same beneficiaries, and (3) sharing the process of targeting and selection of beneficiaries. In this model, CCTs are temporary, and the social intervention prioritizes permanent links between beneficiaries and the stable SP network in the country, ensuring that at the end of the program, families learn about and make effective use of that network.

### ***Improving Crisis Response Capacity***

The crisis response capacity of targeted programs remains limited. Although their main focus is to address structural poverty, income support programs can help when shocks affect their beneficiaries. But the “triple F” (food, fuel, and financial) crisis of 2008–09 and the 2009 global economic slowdown have shown that this potential is still under developed. During these crises, some LAC countries were able to adjust benefit values or eligibility thresholds for CCTs to offset inflationary effects and protect consumption for the poorest.<sup>14</sup> But only six CCT programs (out of the 16 in the region) were able to do this.<sup>15</sup> Other programs had insufficient budgetary and administrative flexibility to respond in an agile way to the crisis. This is a challenge for the future.

Another challenge is that crises do not only affect the extreme poor who are targeted by the CCTs. Governments also need tools to support other, less-poor families hit by covariate shocks. As mentioned, the most common response to unemployment spikes among uninsured workers is to use workfare programs. Such programs in LAC include *Trabajar* and *Jefes* in Argentina, the *Trabajo por Uruguay* component of PANES in Uruguay, *Plan Nacional de Empleo de Emergencia* (PLANE) in Bolivia, *Empleo en Acción* in Colombia, *Construyendo Peru* in Peru, and PET in Mexico. These programs generally have had a positive impact on the employment and poverty status of their beneficiaries. *Jefes* in Argentina reduced overall unemployment by 2.5 percentage points, reduced the national poverty rate by 2 percentage points, and reduced extreme poverty among its beneficiaries by 10 percent (Galasso and Ravallion 2003). Evaluations of Bolivia's PLANE indicated that the program had positive effects on the income of its beneficiaries, especially women (Landa and Lizárraga 2007). In Colombia, *Empleo en Acción* increased the consumption of beneficiary families by 9 percent (Programa Empleo en Acción 2004).

Interest in workfare was revived in the context of the global financial and economic crisis, as a viable way to protect uninsured individuals against unemployment shocks and especially, to provide a safety net for workers during downturns and crises. However, they usually have modest impact on unemployment at quite high costs, so there is still considerable scope to improve their design and strengthen their impact. Wages should be kept as low as is legally feasible to allow programs to assist the largest number of beneficiaries and to provide incentives for workers to accept jobs elsewhere. Also, as a general rule, they should be scaled back when unemployment levels recover. Public works programs also can sometimes be implemented in conjunction with training opportunities and active labor market programs to help beneficiaries find permanent employment.

### ***Avoiding Perverse Labor Market Incentive Effects***

Some income transfer programs may discourage labor supply and create incentives to informality. Despite the positive effects of recent developments in LAC's income support programs, there are concerns that they could undermine incentives to work, displace people from the formal sector, and lead to welfare dependency. As with noncontributory SI programs, when eligibility depends on having an income below a stated threshold, the benefit from targeted income transfers becomes a marginal tax on any formal sector income above the threshold

for program membership. This can cause beneficiaries to stop looking for work or to bend the rules by working in the informal sector while also claiming the transfer (“moonlighting”). Good design can prevent this problem from arising in either of the main classes of transfer programs that exist in LAC—workfare and CCTS—but that does not always happen.

In the case of *workfare*, beneficiaries normally must work or participate in training, so they cannot claim the benefit and remain idle. This is similar to the design of unemployment assistance under the welfare-to-work reforms in member countries of the Organisation for Economic Co-operation and Development (OECD),<sup>16</sup> and it should reduce the problem of “moral hazard.” Nevertheless, the evidence suggests that design factors such as program rules and benefit levels in LAC’s workfare programs can affect the interplay between formality and informality and labor force participation rates in several ways.

One obvious problem is that, when workfare programs have loose work requirements, the effect is likely to be a boost in demand for informal work among beneficiaries. The second common problem is that wages often are set too high. Ideally, workfare programs should pay wages that are lower than the market wage, to ensure self-selection of poor beneficiaries and to avoid distorting labor market incentives. But because of legal requirements or political economy factors, workfare wages sometimes are set above the (informal sector) market wage for unskilled labor, which is normally below the legal minimum wage. When this happens, workfare becomes expensive and the relatively high wages may discourage people from finding other employment. The third common problem is that it may be difficult to eliminate workfare programs if clear exit rules are not defined at the outset. The experience of PLANE in Bolivia illustrates the impact of setting relatively high wages and not having exit rules established at the outset (see box 1.1).

The effect of high wages in a workfare program was evaluated rigorously for the case of the *Jefes* workfare program in Argentina. During 2003–04, when the *Jefes*’ benefit was 75 percent of the formal sector minimum wage, membership of the *Jefes* program reduced the likelihood that workers would move into formal employment by 3.5 percentage points. However, during 2004–05, formal sector earnings rose considerably, whereas *Jefes*’ benefit remained fixed in nominal terms. As a result, the disincentive effect disappeared (Gasparini, Haimovich, and Olivieri 2007). One option to facilitate setting workfare wages at an appropriate level is to designate them as training programs.

**Box 1.1****The Effect of Setting Workfare Wages Too High: The Case of PLANE, Bolivia**

PLANE (*Plan Nacional de Empleo de Emergencia*) was a temporary workfare program that operated in Bolivia between 2002 and 2005. It was set up in response to a rapid rise in open unemployment (from 6 percent to 9 percent of the working age population between 1999 and 2002) and in underemployment (up from 16 percent to 21 percent in the same period). During those three years, it financed around 800,000 job-months. Eighty percent of funding for PLANE came from bilateral donors. The target population was poor people age 25 to 55 years old. Employees worked for seven hours per day for up to 10 weeks. The salary for unskilled workers was Bs. 480 (slightly above the minimum wage), while skilled workers received Bs. 1,600 per month. Resources were allocated using geographic targeting based on an index of municipalities' unmet basic needs. PLANE was extended well beyond the crisis and became difficult to close down due to a perception by the beneficiaries that they were entitled to ongoing employment. In 2006, the incoming Morales administration decided to close PLANE but encountered strong opposition from a union of PLANE employees. Eventually, PLANE was fused with a social fund project, *Pro País*, and PLANE beneficiaries were given the option of working temporarily on a *Pro País* project.

*Sources:* Bouillon and Tejerina 2006; Landa 2003.

In contrast to the problems observed with badly designed workfare programs, the evidence confirms that, thus far, no important work disincentive effects have resulted from CCT programs in LAC. On the contrary, these programs may have resulted in positive impacts on work and income because of the improved capitalization of poor households.<sup>17</sup> This is not surprising. Because of the way CCTs are designed, a priori it is much less likely that they will cause negative labor market incentive effects. In most countries, eligibility is based on a proxy means-test that is updated infrequently. Thus, it is unlikely to create an implicit marginal income tax that might discourage work. In addition, the benefit levels of CCT programs normally are too small to encourage people to forego other earnings opportunities to retain their CCT benefit.<sup>18</sup>

Developing new behavioral conditions for CCTs in urban labor markets that focus more on requirements to participate in training and work search—similar to the requirements of welfare-to-work programs

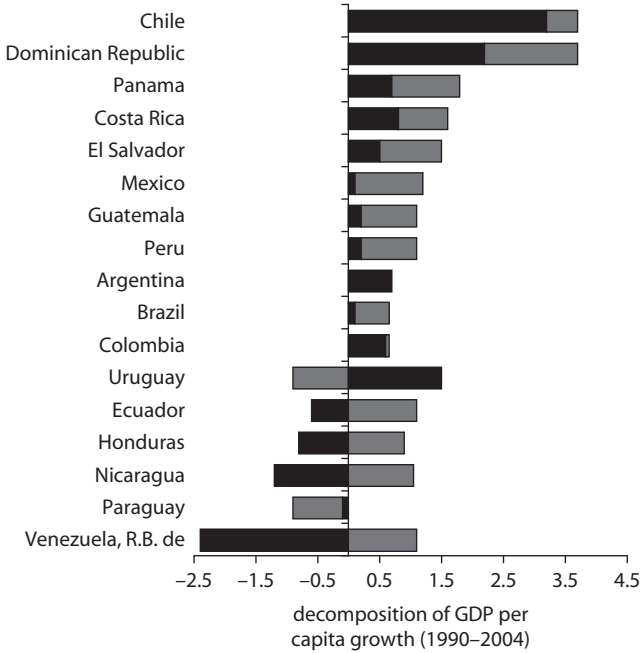
in the OECD—is another option to reduce labor market disincentive effects. Challenge V explores options to strengthen access to jobs for low-income workers.

**Challenge V: Increasing Access to Quality Jobs**

Many of the jobs that have been created in LAC in recent years are low-quality, informal sector jobs, characterized by low productivity and earnings and by insecurity. These jobs employ mainly unskilled workers and young people. In many countries, GDP per capita has been growing mainly as a result of an increase in the employment rate and not because of an increase in the average productivity of workers (see figure 1.17).

Many of the causes of these poor labor market outcomes are outside the sphere of SP. They include problems in the business environment, which undermine incentives to invest, to adopt new technologies, and to enter

**Figure 1.17 GDP per Capita, Labor Productivity, and Employment Growth**



Source: Authors' calculations.

Note: GDP = gross domestic product. For each country, the average annual rate of per capita GDP growth that was achieved between 1990 and 2004 is decomposed into the part attributable to productivity growth (shown in black) and the part attributable to changes in the ratio of employment to population (shown in gray).

new product markets. Nevertheless, SP policies can make a difference. They can facilitate employment creation and labor mobility by reducing tax wedges (which remain high in many LAC countries), by easing regulations on labor contracts, and by ensuring that workers have access to adequate income protection programs. In addition, well-designed ALMPs can address skills mismatches arising from a lack of information among labor market participants or from structural imbalances between the supply and demand of skills. Regrettably, however, setting up these programs is challenging and few of LAC's income protection systems and ALMPs are yet up to this task.

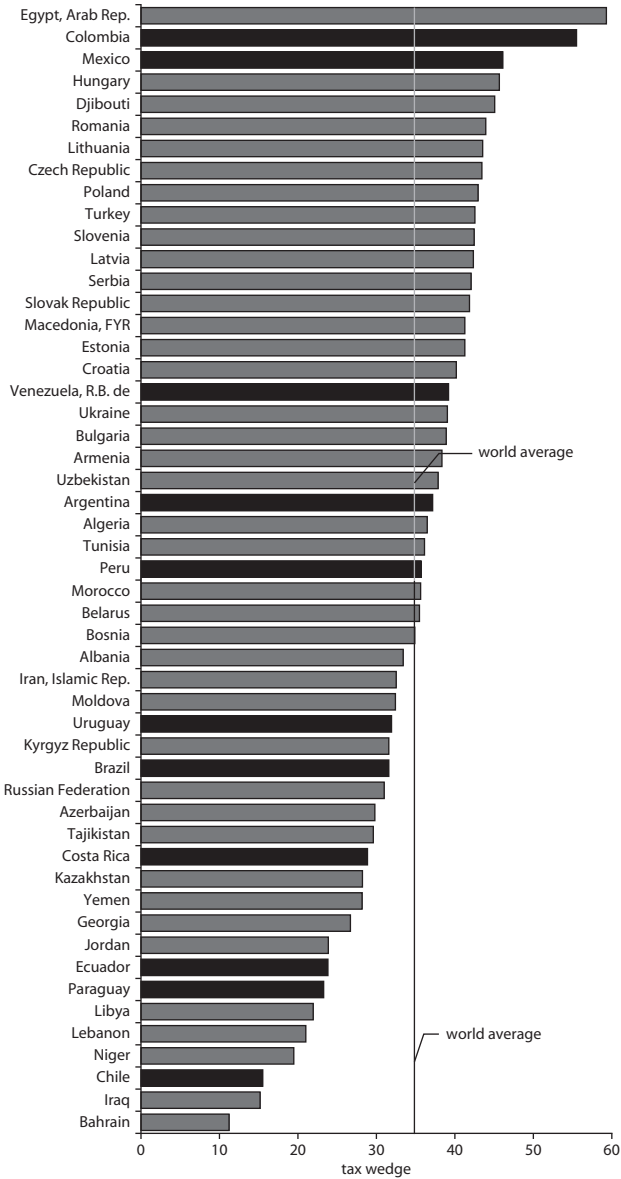
Most of LAC's income protection systems still rely on severance pay, which is an ineffective option, to smooth the consumption of workers who lose their jobs. The coverage of UI programs or UISAs, which are more effective options, is very low.

At the same time, ALMPs in LAC have evolved in an ad hoc manner rather than as an informed response to the market failures that need to be addressed. The systems are fragmented, in that many diverse institutions are involved in designing and implementing programs, often with no coordination. The main focus of ALMPs has been on training programs, which tend to be supply driven and often fail to align the incentives of program managers, job-seekers, and employers. Intermediation and job search assistance programs are not sufficiently developed, and monitoring and evaluation systems are generally weak.

ALMPs also tend to focus on providing services to those in the formal sector, thus neglecting informal workers and the poor. Most programs operate in partnership with formal employers and fail to address the needs of small producers in the informal sector. These programs mainly serve workers who have completed their secondary education, while poor and unskilled workers are less likely to benefit. As noted under Challenge IV, some countries have created workfare programs to help poor workers through the fluctuations in labor demand and to provide short-term support to smooth the consumption of uninsured workers; however, these programs are costly, have limited coverage, and rarely are coordinated with ALMP training and job search services.

Unnecessarily high tax wedges are another factor that constrains access to quality jobs in many LAC countries. As discussed above, high tax wedges can depress the demand for labor from the formal sector and encourage informality. Estimates of the size of tax wedges in the region vary between 15 percent (Chile) and 55 percent (Colombia) (see figure 1.18). Often, this reflects the proliferation of nonessential benefits, such as recreational facilities, child care, or family allowances. In some pay-as-you-go pension

**Figure 1.18 Tax Wedges in LAC Countries and the World**



**Source:** World Bank staff calculations based on country data.  
**Note:** The tax wedge is defined as (employers’ costs of labor – employees take-home pay) and is expressed as a share of total labor costs. Formally: where  $w$  is the gross wage,  $\beta$  is the contribution rate paid by the employer ( $e$ ) and the employee ( $l$ ), and  $\tau$  is the income tax. For each country, the calculations were made for the worker earning average earnings based on social security and income tax legislation.

systems (such as Brazil, Nicaragua, or Uruguay), the risk arises that the tax wedge will need to increase further, either through higher contributions and payroll taxes to align system revenues with costs, or through income tax increases to fund the deficit. Population aging also puts pressure on health expenditures and on the required contribution rate in SHI systems.

## Notes

1. Pension coverage can be measured either at the contribution stage or at the payout stage, but regardless of which way it is measured, pension coverage in LAC is low with significant inequalities across the income distribution. The data cited in the text are based on the coverage rate of the EAP, but Forteza, Lucchetti, and Pallares (2009) show that coverage at the payout stage resembles the trends and inequalities for the EAP.
2. Turnover is measured by the *transition rate*, defined as the percentage of individuals in a given gender, age, or income category who leave the social security system in a given month (for reasons other than retirement).
3. Noncontributory insurance schemes in health also respond to the poor quality and limited scope of services offered by the universal, but fiscally constrained, NHS systems.
4. NHS systems often collect user fees (co-payments) for some services. Since this can undermine effective universal access, special free windows for NHS services have been created, in the form of targeted integrated health insurance programs that reimburse NHS clinics for the variable cost of services provided to the poor.
5. Many of the Caribbean island states not included in this table do have stand-alone NHS systems.
6. In some cases, the operation of hospitals and clinics has been decentralized to subnational governments. This is often so in federal republics (such as Brazil and Argentina) and has also happened in unitary states such as Peru.
7. Systematic redistribution is different from the nonsystematic redistribution of income that exists within any given risk-pooling arrangement. In a risk pool in which all insured individuals face the same risks (or, alternatively, one in which risks vary, but the members contribute premiums that reflect their differential risks), income would not be systematically redistributed. Any redistribution would be the result simply of the random incidence of the insured events. Sometimes individuals would “gain” (collect benefits), and sometimes they would “lose” (only pay premiums). In contrast, systematic redistribution occurs when individuals in the pool do not contribute as a function of their specific risks. As a result, their contributions do not reflect the expected (probability-weighted) costs of their benefit plan.

8. In some cases, subsidies reflect the transition costs of pension reform and thus exaggerate the long-term subsidy element of the social insurance system. However, these transition costs are themselves long term and mostly benefit non-poor households at the expense of the general taxation fund.
9. The tax wedge can be defined as the difference between the total cost of labor paid by the employer (which includes payroll taxes) and take-home pay (which is equal to the gross wage minus workers' social security contributions and income taxes). In principle, social security contributions that are directly proportional to social security benefits are not considered a tax. Similarly, payroll taxes that are directly proportional to benefits can be considered to be part of the compensation package and, therefore, have less of a negative effect on employment.
10. Income taxes also contribute to the tax wedge, but they are normally at least as progressive as SI contributions. Also, there is little evidence that they are less acceptable to workers than SI contributions, so a shift from SI contributions to income tax as a source of funding would be unlikely to lead to negative reactions. Income taxes are likely to be more efficient than payroll taxes levied on employers. The general issue of the sociopolitical choices to be made in structuring the tax system between different types of instruments for raising revenue—such as sales tax, income tax, and property tax—goes beyond the scope of this study. For an excellent review, the reader is referred to Auerbach and Shaviro (2008).
11. In the case of some noncontributory programs such as the Bolivian social pension, *Renta Dignidad* moving into the formal sector does not lead to a loss of benefits—there is no tax. The cost of a universal pension, however, is much higher (see Holzmann, Palacios, and Zevine 2004). In many national health services, moving into the formal sector does not lead to a loss of benefits from the subsidized program. The availability of a free health service of similar quality to the one provided through the contributory insurance system, however, renders the value of the contributory benefit null and thus converts the corresponding contribution into a tax.
12. The net benefit of an insurance program is defined as the expected value of the benefit minus the cost of the contribution. In noncontributory programs, by definition, net benefits equal gross benefits.
13. Paes de Barros, Foguel, and Ulyseia (2006) found a strong causal link between *Bolsa Familia* and the recent reduction in Brazil's Gini coefficient.
14. The evidence is also clear that cash benefits that are conditional on the use of health, nutritional, and education services can make a big difference to how households reallocate their labor supply and income in response to crises, helping to reduce short-term coping responses that have negative long-term consequences. De Janvry and Sadoulet (2006) showed that the beneficiaries of *Oportunidades* were less likely to respond to systematic or idiosyncratic shocks

- by withdrawing their children from school than households not enrolled in the program.
15. Brazil, Chile, Colombia, El Salvador, Mexico, and Panama.
  16. For a review of how welfare programs in OECD countries affect labor markets, see Grosh et al. (2008). Moffitt (1992 and 2002) estimated that income support for single mothers in the United States (in the Aid for Families with Dependent Children program or AFDC) reduced their work effort somewhere between 10 and 50 percent because the program's rules converted the benefit amount into an implicit tax on any earned income. This led to the welfare-to-work reforms of the 1990s in the United States and Europe, the purpose of which was to eliminate incentives for recipients of income support to pursue unemployment or informality. In the United States, the Temporary Program for Needy Families (TANF) program incorporated many design elements that encouraged beneficiaries to work. As a result of these reforms, open unemployment and informal employment ("moonlighting") were drastically reduced.
  17. Skoufias and di Maro (2006) found that *Progresa* had no significant effect on adult labor force participation in Mexico. Maluccio and Flores (2004) found that *Red de Protección Social* in Nicaragua had no effect on adult participation rates or on the hours worked by women. Leite (2006) simulated the effect of Brazil's *Bolsa Família* on adult work effort and found that the program had little impact. On the other hand, two studies found a considerable (and desirable) reduction in child labor was associated with CCT participation in Ecuador and other countries as a result of income effects and education conditionalities (Schady and Araujo 2008; Skoufias and Parker 2001).
  18. In contrast, when CCT programs use self-declared income as the basis for program eligibility—as is done, for example, in *Bolsa Família* in Brazil—the risk is greater that (if the benefit is high enough) they might discourage work or displace workers into informal work. Various possible approaches can deal with this problem, including (1) allowing people to stay on the program for a significant amount of time before income is reevaluated; (2) having different income cutoff points for program entry and exit, which would allow beneficiaries' incomes to grow without having to leave the program; and (3) tapering the subsidy above a certain level of income instead of cutting it off all at once.

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## CHAPTER 2

# A Policy Framework for Social Protection in Latin America and the Caribbean

This chapter lays out a conceptual framework for understanding the objectives and elements of an SP system, the interactions between instruments and programs within the system, and their impact on the economy as a whole. We then use this framework in the following sections to address the challenges outlined in chapter 1 and suggest a way forward for increasing the coverage and adequacy of SP in LAC.

### **Conceptual Framework: Understanding the SP System**

The framework developed here distinguishes three different levels—objectives, instruments, and financing mechanisms—and puts particular emphasis on the behavioral responses of workers, households, firms, and SP service providers to the systems' rules and incentives.

#### **Objectives**

*Smoothing consumption* and *preventing poverty* are widely recognized as objectives of any SP system.<sup>1</sup> When a shock materializes that reduces incomes, policies need to be in place to enable all individuals and households to replace part of their income and, thus, smooth their consumption. To prevent poverty, the SP system must not only protect low-income

individuals from shocks but also provide additional transfers to raise their long-run consumption capacity above a socially acceptable minimum.

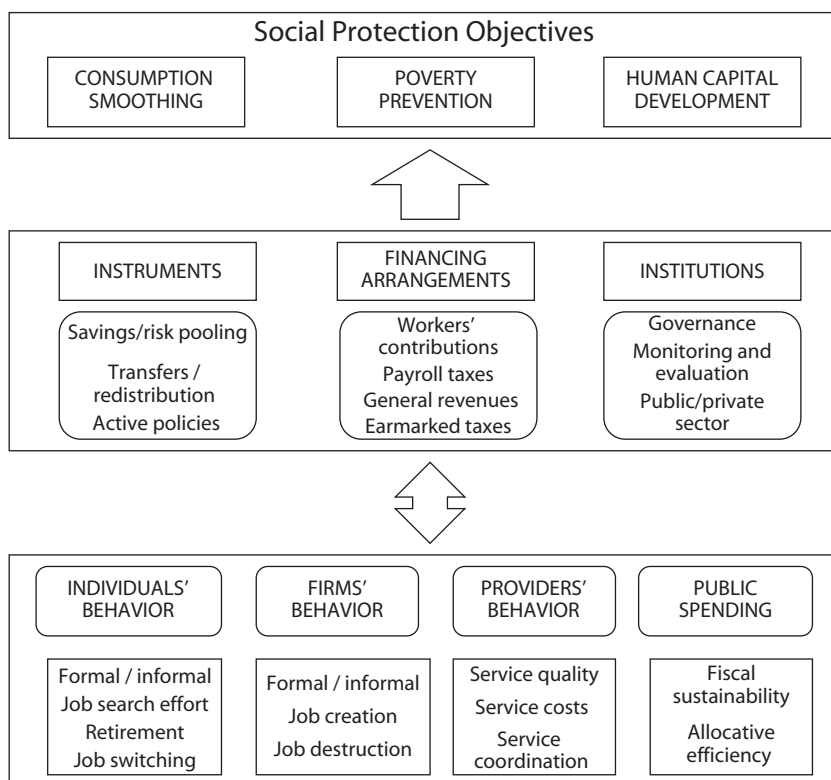
The framework developed in this study also makes explicit the objective of *promoting human capital* to increase individuals' earnings capacity, reduce their exposure to risk, and help them to manage idiosyncratic risks.<sup>2</sup> The goal is to give low-income individuals an incentive to invest in their own human capital and promote the productive use of this human capital, for instance, by facilitating their access to jobs.<sup>3</sup> This helps to reduce their exposure to risks such as disease or unemployment, because better-educated and healthier individuals are less likely to become unemployed or sick. Easier access to jobs or credit also reduces the risk of remaining unemployed. Having access to more productive activities with higher incomes gives people more options to devise risk-prevention strategies.

These three objectives have clear trade-offs. If the SP system fails to promote human capital as a way to reduce risks and encourage private and individual protection, then the system will be forced to spend more on public consumption smoothing and poverty prevention programs. Putting too little focus on consumption smoothing, on the other hand, will create the need for larger assistance programs for the poor, as some people will fall into poverty because of their lack of access to social insurance programs.

To achieve these three objectives, the framework distinguishes three types of policy choices: (1) the choice of instruments and programs; (2) the choice of financing mechanisms; and (3) the choice of implementation arrangements. Several combinations of these three kinds of policies are possible, which explains the diversity of SP systems across the region. It is clear that each policy choice will affect the behavior of individuals, employers, and providers and the efficiency of public spending (see figure 2.1).

### ***Instruments***

The available instruments to deal with the first two objectives are SI programs, which promote savings and risk-pooling (insurance), and targeted transfers (redistribution).<sup>4</sup> Savings and risk-pooling are alternative forms of consumption smoothing.<sup>5</sup> Targeted transfers are the main poverty prevention instruments, but they also may form a part of a well-designed SI system to ensure that low-income households have access to coverage. The savings arrangements discussed in this report include defined-contribution mandatory pensions, UISAs, and health insurance savings accounts. In all of these cases, individuals save money in individual accounts to finance

**Figure 2.1 A Conceptual Framework for Social Protection**

Source: Authors.

their consumption if their income falls as a result of unemployment, disability, or retirement or if their expenditures increase as a result of sickness. Risk-pooling arrangements include pension annuities (which insure against the unpredictability of an individual's life span after retirement), UI or severance pay, and health insurance. In these arrangements, individuals and employers each pay a premium or contribution (usually based on each worker's earnings). These accumulate in a collective fund to finance the benefits paid to those members affected by unemployment, sickness, or other risks or life events.

Redistribution through transfers is another important tool for protecting individuals with limited savings capacity and the long-term poor through programs such as minimum pension guarantees, subsidized health insurance, and various forms of social assistance or income support programs.

The framework distinguishes between *systematic* and *nonsystematic* redistribution and between *explicit* and *implicit* redistribution. In pure savings arrangements, there is no redistribution, since each person's savings are his or her own. In a pure risk-pooling arrangement, the redistribution of income is nonsystematic, in other words, all members of the risk pool face the same risks so they have the same probability of receiving a transfer. As discussed in chapter 1, however, in the typical LAC SI system, all individuals do not face the same balance between contribution rates and risks, and some rules (such as minimum benefit levels) can make income redistribution systematic, in the sense that some plan members systematically receive more than they put in, which implies that other members systematically receive less.

The resulting redistribution is normally *implicit* rather than *explicit*, in the sense that it is unclear ex ante which groups receive the transfers and which finance them. Nor is the real cost of the transfers clear. As a result, it is difficult to control negative incentive effects. Explicit redistribution, on the other hand, is targeted to specific groups, the level of the transfer is defined up front, the costs are known, and the most efficient financing mechanism can be adopted.

In terms of the third objective, *human capital promotion*, which aims to reduce individuals' risks by improving their labor market outcomes, the instruments that are discussed in this report include health services, CCTs, and ALMPs. Health and nutrition services—especially those focused on pregnancy and the early years of life—can have a major impact on human capital outcomes (both physical growth and cognitive attainment). As well as having a direct poverty prevention effect, CCTs also give low-income households an incentive to invest in their children's education and health. The main aim of ALMPs, on the other hand, is to improve the match between the supply of the skills possessed by potential workers and the labor market's demands. These programs include training, retraining, and skill recertification programs (which aim to make individuals more *employable*) and programs that provide labor market intermediation, job search assistance, and relocation grants (which aim to overcome *job search constraints*).

### ***Financing Mechanisms and Institutional Arrangements***

An SP system can have many different sources of revenue and levels of funding. The choices made can have labor market and fiscal implications and also affect the coverage and adequacy of SP. Most SP systems in LAC are financed in three ways: (1) by payroll taxes (paid by employers) and

social security contributions<sup>6</sup> (paid by employees and collected in the workplace); (2) by general government revenues; and (3) by earmarked taxes. Payroll taxes and social security contributions mainly finance SI programs (such as pensions, unemployment benefits, and health services), although several countries also use the payroll to finance ALMPs.

General revenues are the most appropriate way to finance social assistance programs, such as CCTs and health expenditures for those not covered by social security. However, they also are used often in LAC countries to cover deficits in SI systems where the contributions of plan members are not enough to cover the promised benefits. In countries that have introduced funded pensions, general taxation also is used to finance the transition costs, that is, the cost of honoring the pension obligations already acquired by the old system at the time of the reform. Earmarked taxes have been introduced more recently in some countries to finance both social assistance and SI programs.<sup>7</sup>

In addition, any SP program can be “funded,” “pay-as-you-go,” or a mixture of the two. In funded programs, the revenues from taxes, contributions, and transfers accumulate and are invested in financial assets. The program is regarded as solvent if the present value of its projected liabilities does not exceed the value of its financial assets. In pay-as-you-go systems, on the other hand, there is no accumulation of financial assets. The revenues from taxes and contributions are used directly to finance the benefits. As discussed, a pay-as-you-go system is well balanced if the present value of its projected liabilities does not exceed the present value of the future income stream (the so-called pay-as-you-go asset) plus its investment assets. In practice, few systems are purely pay-as-you-go. Most systems are partially, but not fully, funded.

In health, while solvency is essential, so is short-term liquidity. Indeed, health care often needs to be provided urgently. *In extremis*, delays in providing treatment can put lives at risk, and it often can increase the risk of complications and of the infection of third parties, leading to increased costs. Therefore, it is preferable that most of the cost of contributions and subsidies should be prepaid and pooled to remove financial barriers to access for those in need, at the moment when care is needed. It follows that health benefits in SI systems normally are provided not in cash (the reimbursement of expenditures) but in kind (the direct provision of services by an approved provider, free at the point of demand).

The effectiveness of any SP program depends on the arrangements chosen for its implementation. These include institutional organization, governance structures, management and administrative systems, information

systems, and monitoring and evaluation systems. The choices made by policy makers regarding these arrangements will determine the program's accountability to users and funders, the incentives that it will create for managers and providers, and, ultimately, its operational costs and the quality of its services.

### ***Indirect Effects and Behavioral Responses***

The framework used in this study highlights the way in which the choice of SP instruments, financing mechanisms, and institutional arrangements affects the behavior of individuals, firms, and providers and affects the government budget and the efficiency of public spending. As analyzed in chapter 1, SP instruments and financing mechanisms influence *the choices of the working-age population*. These choices include the decision about whether to participate in the labor force, whether to take a formal or informal sector job, whether to declare wages to the tax authorities, how much time to invest in searching for a job, when to retire, and whether to attempt to “game the system” when applying for disability benefits.

Workers will make these decisions in response to the benefit formulas and eligibility conditions of SP programs, the level of social security contributions, and the resulting implicit tax or subsidy to program participants. For instance, if social security contributions increase but benefits remain unchanged, this reduces the take-home pay of formal sector workers and increases the “wedge” between the full cost of labor to the firm and the worker's take-home pay, which may, in turn, discourage work effort and encourage informality.

In general, the less transparent the rules on benefits and taxes, the more prone they are to being abused and the more likely it is that they will induce undesirable behavior. This, in turn, can increase the fiscal costs of programs, reduce firms' productivity and output, and cause regressive redistribution (favoring the non-poor).

The SP system also influences *the behavior of firms and employers* who will act in response to regulations on hiring and dismissal and to the level of the payroll tax, which affects labor costs. These policies can influence employers' decisions to invest, to operate in the formal or informal sector, to finance training for their employees, and to hire or fire workers as reflected in job turnover rates and employment levels.

A third important set of actors whose behavior can be affected by the design of SP systems are *the managers and providers of SP benefits and services*. The institutional arrangements for SP programs can affect their performance in various ways. Well-thought-out rules on how managers'

performance is rewarded (or penalized) can give them an incentive to manage their programs in the best interests of the members and to make them more efficient and improve their quality.

Institutional arrangements also can affect a program's funding. For instance, a monitoring and evaluation system might produce convincing evidence that a program is producing good outcomes, which might in turn persuade the government to increase the program's funding and give its managers greater autonomy to design and implement their own action plans and human resources policies.

Contracting and payment systems also affect the performance of providers. In countries with privately managed pensions, the contracting system affects the program's administrative costs, which in turn affects the price of annuities. In health, the way in which insurers or financing agents contract with service providers affects the cost and quality of services. As indicated above, in many health systems, financing and service provision are organizationally integrated. NHS systems receive budgets to operate clinics and hospitals. Similarly, SHI systems often combine insurance and service production functions. The efficiency of systems might be enhanced if these two functions were separated (see the discussion in chapter 3).

Finally, SP policies affect the *government budget*, having consequences for current expenditures and for future government liabilities. Such liabilities need to be analyzed with caution. In a pay-as-you-go pension system, for example, a policy change that has no apparent short-term impact on the budget might still produce large, unfunded liabilities for the future, which are analogous to a public debt. Similarly, the cost of a cash transfer program might seem fiscally sustainable in the short term, but when population trends are taken into account, the future costs might become unaffordable. SP policies also affect the overall efficiency of public spending. The fiscal resources spent on SP, which normally represent a considerable share of the government budget, could potentially be spent on other programs. If the social rate of return of SP programs declines relative to that of other programs, the allocative efficiency of the fiscal system will be reduced. Evaluating opportunity costs is a difficult task, but it is important to recognize the potential trade-offs.

## **Policy Implications of the Conceptual Framework**

This section lays out key steps to enable LAC's SP policy makers to turn the right to SP into a reality for millions of workers across the region. The

central ideas are (1) that *contributory SI* should be opened up to informal sector workers on an optional basis with adequate financial and institutional incentives; (2) that SI benefits should be aligned with the value of contributions; and (3) that subsidies should be transparent, targeted to workers with limited savings capacity, and financed out of general taxation. Wherever possible, SI programs covering different populations or risks should be consolidated and their benefits packages harmonized. At the same time, *safety net programs* aimed at reducing poverty should be targeted based on poverty criteria, and program rules should avoid creating disincentives to work or save. More emphasis should be placed on interventions that *promote human capital* and reduce vulnerability by strengthening links from SP programs to improved health, nutrition, and education outcomes. Policy makers need to improve the design of ALMPs to help the most vulnerable workers (especially young people entering the labor market and low-income unskilled workers) get better quality jobs and avoid long-term unemployment. Finally, policy makers should coordinate policies across different types of program to take advantage of potential synergies and cross-effects and to avoid adopting policies with conflicting aims.

The five key steps to implement this agenda are as follows:

- *Open up contributory SI programs to all workers*, regardless of where they work. This means not only maintaining mandatory insurance in the formal sector but also promoting the inclusion of informal sector workers in contributory SI programs on an optional basis, with adequate financial and institutional incentives.
- *Review the mandates of SI programs*. The objective is to make explicit choices about the coverage and benefits to be offered to individuals with different levels of income. These choices need to be adequate, efficient, and affordable.
- *Make subsidies transparent and progressive*. The idea is to remove implicit taxes and subsidies within SI programs and move toward a unified system of subsidies that are targeted based on means. These subsidies would decline gradually as the beneficiary's income rose and would be financed from general revenues. This would make redistribution more progressive and avoid distorting incentives for workers and employers.
- *Make SP systems more coherent* by integrating or harmonizing parallel programs and exploiting opportunities to share savings and insurance

pools between risks. Policy makers need to rationalize the interactions among SI programs, safety net programs, and ALMPs.

- *Deepen the antipoverty social safety net and develop programs to facilitate access to better jobs.* Cash or in-kind transfers are needed for workers and households in extreme poverty who have no capacity to participate in contributory SI, even with subsidies. A key objective is to ensure that these social safety nets encourage poor households to invest in their education, health, and nutrition to avoid the intergenerational transmission of poverty. In parallel, ALMPs are needed to help low-income and low-skilled workers increase their employability and to facilitate labor mobility and job search. This can increase their earnings and reduce their vulnerability, thus relieving pressure on other elements of the SP system.

## Opening Social Insurance Access to All

The central goal is to give all citizens or residents access to the same SI system—under the same rules and conditions—regardless of where they work.

SI financed from beneficiaries' contributions (and employers' contributions, when available) would remain mandatory in the formal sector.<sup>8</sup> But it also would be opened up to informal sector workers on a voluntary basis. These would not be special, second-class programs, but rather the same programs available for the formal sector, with the same basic packages of contributions and benefits.

Expanding the coverage of contributory systems to the informal sector and rural agricultural workers presents several challenges. These workers often are employed in small firms or are self-employed. They often are unskilled, with low incomes and limited savings capacity. They often are not permanently employed, and their incomes fluctuate seasonally. They also tend to have high personal discount rates and strong preferences for liquidity. Many have little contact with or access to financial sector institutions.

To offer services to these workers, SI programs need to adopt appropriate rules and payment and contribution collection systems. First, even when universal insurance mandates are created *de jure*, the reality is that it is very difficult *de facto* to enforce a mandate on this population, so programs need to be attractive to persuade them to join. Second, in many cases, these workers are not wage-earners, so their contributions need to

be set in the form of flat payments, not as a proportion of wages, and contribution scales need to accommodate individuals with different savings capacities. As discussed later (*Reforming Social Insurance Subsidy Systems to Remove Implicit Redistribution*), this implies that an individual's benefits need to be directly proportional to his or her contributions plus any means-tested subsidies he or she has received. Third, a proactive mechanism is needed to market the insurance programs and collect contributions (for example, mobile agencies that could be set up in markets and travel to remote geographic areas). Fourth, transaction costs have to be reduced because the contributions of many of these workers are likely to be small. Fifth, restrictions should be relaxed on vesting periods for the payment of benefits, because many plan members may not be able to achieve high contribution densities.

Some of these problems can be addressed, in part, by subcontracting “aggregators,” such as cooperatives or trade associations in the agricultural and services sectors, to enroll workers and collect contributions. This would generate economies of scale and reduce transaction costs. In addition, financial incentives are needed to attract individuals with limited savings capacity, who would not be able to save enough by themselves to cover adequate benefits or to pay insurance premiums in full. These ideas are discussed in more detail in the next section.

### **Reviewing the Mandates (Benefits Packages) of Social Insurance Programs**

For each SI program, the first step would be to define its objectives, in terms of the coverage and benefits to be offered to people with different levels of income. No one set of SP mandates (or benefits packages) is “correct.” The choices made will vary from country to country, reflecting social preferences about the appropriate balance between the responsibility of individuals compared with that of the government.

In general, the factors that must be taken into account when defining the mandates of SI programs include *the adequacy of the benefits, the efficiency of the program, and its affordability and sustainability*. Benefits need to be sufficient to guarantee that individuals can preserve a decent standard of living and do not fall into poverty after a shock or life event (*adequacy*). They should not, however, be set at such high levels that they discourage individuals from saving or distort their labor supply decisions (*efficiency*). Nor should the subsidized element of the benefits put an unsustainable burden on public finances (*affordability or sustainability*).

**Box 2.1****The Limitations of Funding SI Entirely from General Taxation in LAC**

Previous studies have argued that it is ineffective to finance SI through payroll taxes on employers and workers' SI contributions, while having parallel noncontributory schemes, because of problems related to lower employment levels and greater informality, as discussed in chapter 1. These problems have led some experts to advocate systems with no beneficiary contributions that would offer basic benefit packages (health, pensions, or unemployment benefits) to all citizens or residents, regardless of their income level or where they work. The costs would be financed entirely from general revenues and earmarked taxes. Those wanting extra protection or insurance would be free to enroll in voluntary, complementary plans that could be managed by the public or private sector.<sup>9</sup>

Although it is attractive in principle, this proposal has not yet gained much traction with policy makers in LAC. Many countries have significantly increased tax-funded expenditures in health and in income support, but apart from the Brazilian health reform, there are few cases of major SI systems shifting entirely to general taxation. This suggests that such a radical change in the structure and financing of SI may not be feasible in the short to medium term in many LAC countries, particularly given the fiscal, legal, and administrative constraints to such a transformation.

In practice, the proposal to move entirely to a tax-based financing for SI faces several potential drawbacks in LAC. One is the existence of strong social security institutions that already offer health insurance, pensions, and sometimes unemployment benefits, which are greater than the "basic" benefit packages that could be tax funded. To be affordable, the proposal to move to basic packages for all would imply reductions in the mandates of current systems.

This problem is compounded by the low level of general tax revenues (such as income taxes or consumption taxes) in many LAC countries. Countries with a strong element of tax-based finance for SP (for example, in the European Union) normally have relatively strong, progressive tax bases, with low levels of evasion, which provide an adequate basis for financing substantial unemployment and health benefits and minimum pension guarantees. In LAC, where the tax base is narrow and the scope for tax reform is limited, finance ministers are likely to be reluctant to cut workers' and employers' contributions for SI and also are likely to be concerned about the opportunity cost of transfers that subsidize the entire population, regardless of their

*(continued)*

**Box 2.1** (continued)

income. If the budget and the set of taxes that finance it are taken as given, shifting to a system in which basic SI benefits were subsidized for all could induce a regressive redistribution of income.

At the same time, voluntary arrangements are exposed to the standard problems of myopia—which justify government intervention in the first place. From this point of view, it is important to bear in mind that the objective of the SI system is not only poverty prevention but also consumption smoothing.

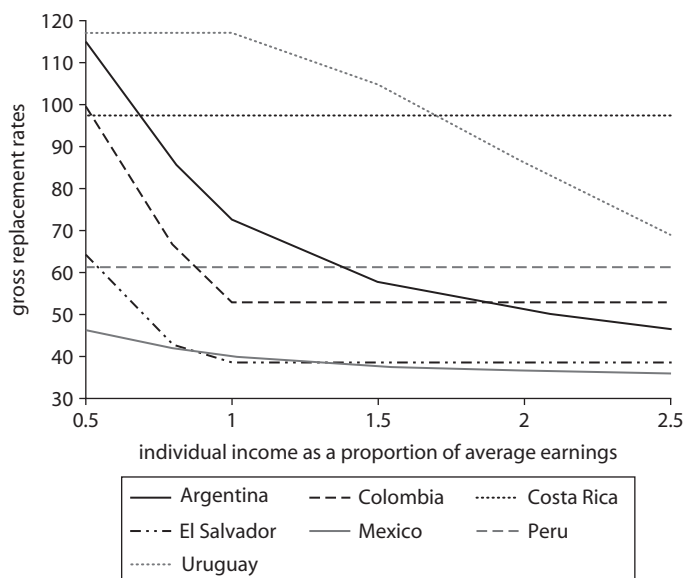
Finally, if at least some workers value the mandate of the SI system and pay contributions related to the benefits they receive (which would not be considered a tax), then the required tax burden also is reduced by having an element of workers' contributions in the financing of SI.

*Source:* Authors.

Clearly, these thresholds are difficult to define a priori. Stakeholders need to discuss the economic impact of alternative mandates, which will vary depending on the country's level of economic development, demographic structure, the productivity of labor, the distribution of income, the availability of natural resources, the efficiency of the tax system, and the extent of informal SP arrangements. Richer countries can afford more generous SI systems than poor countries, because they have more fiscal resources and because a smaller proportion of households need subsidies.

The mandates of *pensions and UI programs* (whether funded or pay-as-you-go) can be characterized by three policy variables: (1) a targeted income replacement rate; (2) a minimum benefit level; and (3) a ceiling on covered earnings. These three variables determine the benefits that individuals will receive.<sup>10</sup> The stipulation of a minimum benefit increases the replacement rate for low-income workers and is an important factor in preventing poverty. The creation of a ceiling, on the other hand, reduces the effective replacement rate for high-income workers. Those who desire a higher consumption level after their retirement would have to make additional savings above and beyond the mandatory system (see figure 2.2).

Characterizing the mandate of the health insurance system is more complex, but similar principles apply. The challenge is to find a balance between the dual objective of improving health outcomes and protecting people against the financial consequences of ill-health. The mandate is

**Figure 2.2** Examples of Different Mandates for Pensions

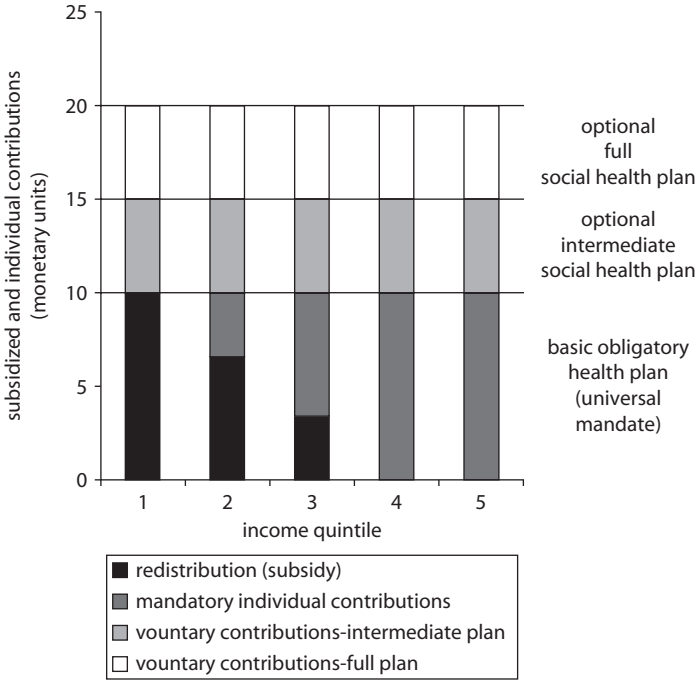
*Source:* Authors' calculations.

*Note:* A flat line implies the absence of a minimum pension guarantees or a ceiling on covered earnings (as in Costa Rica). The minimum pension increases the replacement rate for low-income workers. The ceiling on covered earnings reduces replacement rates for high-income workers. In Uruguay, for instance, the ceiling is close to 100 percent of average earnings.

normally defined in terms of diseases or health interventions covered (positive lists) or not covered (negative lists) by the system. The rules also determine the share of the cost of the plan to be covered by the insured person (annual deductibles), and the share of the cost of specific treatments to be paid by the insured person (user fees or copayments). So explicit social choices need to be made about the health expenditures to be covered by the SI system and the part to be covered by the individual (either out-of-pocket or through voluntary insurance arrangements). This ratio could vary with income level, for example, by giving higher deductibles to high-income individuals. In LAC countries, the mandate of SHI systems aims to ensure universal coverage of basic health services, because preventative, maternal, and child health services are important for improving human capital outcomes for the emerging generation of children and have “merit good” characteristics.

An illustration of these concepts in the case of health insurance is presented in figure 2.3. A basic package is mandatory for all, and means-tested

**Figure 2.3 The Obligatory Mandate and Optional Additional Plans of a Hypothetical Social Health Insurance System**



Source: Authors.

subsidies are used to ensure that the poor can afford it. In this example, for those in the lowest quintile, the subsidy represents 100 percent of the cost of the mandatory package, whereas for those in the highest two quintiles, the subsidy drops to zero. In addition to the basic mandatory package, there might be optional packages such as an intermediate plan or a full plan, which can be purchased with additional voluntary contributions.

When defining the mandate of SI programs, it is important to reduce uncertainty about how benefits will evolve over time. A common mistake—often seen in pensions and income protection programs in LAC—is to define parameters in nominal terms and to be discretionary about adjusting benefits to compensate for inflation. Even with modest inflation, the real value of benefits that are fixed in nominal terms can change radically over time. Similarly, an inflationary climate, having a ceiling on covered earnings that is fixed in nominal terms will gradually exclude most wages from insurance coverage. Such practices create uncertainty about the real effective replacement or reimbursement rates. For this reason,

it is normally preferable to link parameters to specific macro variables—for example, minimum pensions and contribution ceilings can be defined as a share of average earnings, while benefits can be automatically indexed to inflation during the payout period.

### **Making Social Insurance Subsidy Systems Transparent and Progressive**

Expanding social security coverage to all, necessarily involves public subsidies, because many people, such as low-skilled workers in low-productivity jobs, do not have enough savings capacity to cover the full cost of the risks against which they need to be insured. The way in which these subsidies are designed and financed matters a great deal. Implicit transfers that are financed from payroll taxes and from excessive social security contributions, which is currently the prevalent form of subsidy in many LAC SI systems, can be regressive and costly and can distort incentives. Removing implicit redistribution from the contributory systems is important for three reasons: (1) to target the available subsidies to those who need them most; (2) to reduce unintended behavioral consequences (targeted transfers affect fewer workers, usually those with lower productivity, thus reducing the risk of production losses); and (3) to make financing more efficient, for instance, by reducing the tax wedge.

The alternative is to move to a system of explicit, targeted subsidies that, to the extent possible, are financed out of general revenues. Thus, all citizens (or residents), regardless of where they work, would have the same rights to social security coverage—but they would contribute to the financing of the benefits in proportion to their income. High-income workers would pay in full the contributions or premiums that correspond to the risks for which they are covered, while low-income individuals would pay only a portion of these amounts. Subsidies would then be used to top-up the benefits or contributions of these low-income workers to reach the target minimum level. The subsidies would constitute a financial incentive to enroll in social security.

Additionally, a safety net of separate, fully subsidized social assistance or income support programs would continue to be used to create a consumption floor for the long-term poor.

***Removing implicit redistribution.*** The removal of implicit redistribution simply means that in the core SI system, whether it is funded or pay-as-you-go, everyone's contributions would be set at a level that will pay for the expected cost of the benefits that they will receive. This policy *does*

not imply that redistribution would disappear or that reformed systems would lack all forms of solidarity. Redistribution is important for equity and efficiency reasons (externalities), but, wherever feasible, it should be pursued separately from the insurance function of the SP system.

The implication of this change, in practice, is that SI would be based either on savings arrangements (so benefits are determined by the savings that individuals accumulate) or on nonredistributive risk-pooling (so individuals would pay premiums that reflect the cost of the benefit and the risk that the insured event will materialize). In the case of pensions, the natural instrument to use during the accumulation phase is *savings*; while during the payout phase it is *risk-pooling*. Savings are likely to be the preferred option for unemployment benefits, given the difficulty of achieving actuarially fair risk-pooling and the problems related to moral hazard. For health, on the other hand, risk-pooling is the key instrument, because health care costs can far exceed savings capacity. Chapter 3 will discuss how these general concepts could be applied to pensions, unemployment, and health insurance.

This approach also would help to increase the financial sustainability of SI programs. Savings arrangements are sustainable by definition—they pay back whatever workers have accumulated in their savings accounts (whether funded or notional). Risk-pooling arrangements can be sustainable, so long as the insurance premiums cover the expected costs of the benefits provided. Clearly, in some cases, governments also would deal with existing unfunded liabilities. This is the case in most pensions systems with pay-as-you-go financing. Changing benefit formulas can prevent the accumulation of new unfunded liabilities but will not erase the current debt.<sup>11</sup>

***Eligibility conditions and benefit levels for explicit transfers.*** Eligibility for subsidies should ideally be based on earnings and savings capacity and not on workers' occupation, economic sector, or whether they have a formal or informal job. As discussed in chapter 1, a subsidy that is limited to the informal sector is the economic equivalent of a tax on formal work and can increase the share of informal work in the economy. Similarly, a subsidy limited to formal sector workers would exclude unskilled and low-income workers and would be likely to be regressive.

The subsidy amount is important in determining such outcomes. Transfers that are low relative to earnings are unlikely to change behavior. However, minimum pension guarantees that are large relative to earnings can encourage early retirement or reduce contribution densities (see

Robalino et al. 2008). Similarly, large unemployment subsidies (or long-lasting eligibility for benefits) are likely to create moral hazard and lengthen periods of unemployment, thus increasing costs and compromising the program's sustainability (see Robalino et al. 2008).

It is difficult to define exactly when a transfer becomes too large, but average earnings, minimum wages, and the poverty line can provide useful points of reference. Minimum pensions or unemployment benefits equal to or greater than the minimum wage would be likely to reduce incentives for work. In general, the recommended approach is to start with modest benefits, since it is politically easier to scale up programs than to scale down.

In all cases, when eligibility conditions are being designed, policy makers should take into account behavioral responses and cost implications. For example, the retirement age is an important factor in the design of pension transfers. It needs to be set high enough not to produce incentives for workers to retire early or reduce the amount of time that they work. Indexing the retirement age to life expectancy—so that as people live longer, they also work for longer—can considerably reduce the long-run costs of social pensions (see Piggot, Robalino, and Jimenez-Martin 2009). Vesting periods are a less effective tool for controlling costs because compensatory old-age poverty benefits would need to be paid to those who do not contribute for enough years to qualify for their pension. In the case of unemployment benefits, in contrast, the best way to avoid moral hazard and to control costs is to have a vesting period for benefit eligibility and to limit the duration of the benefit.

**Targeting mechanisms.** Where possible, means-tests should be used to allocate subsidies. For a given level of benefits, means-tests can reduce the costs of the program; and, for a given budget, means-tests make it possible to give higher benefits to those who need them most. A recent study of Niger, the Kyrgyz Republic, Panama, and the Republic of Yemen showed that, given the budget constraints faced by those countries, universal pensions would be “spread too thin” and would fail to have much of an impact in terms of reducing poverty (see Grosh and Leite 2009).

As discussed in chapter 1, however, the use of means-tests automatically creates an EMTR on the income of individuals close to the eligibility line, which might affect their work incentives. Workers trying to avoid the tax (or to preserve the subsidy) might decide to work less or take informal sector jobs. The magnitude of this problem will depend on the amount of the transfer and the specification of the income cutoff point.

The greater the transfer amount and the higher the income cutoff point (so that more people are potentially eligible), the bigger the likely effect.

For a given benefit level, however, the lower the EMTR, the higher the cost of the program. Thus, policy makers must assess the trade-off between the need to protect work incentives (which argues for setting a lower EMTR) and the need to contain fiscal costs (which argues for a higher EMTR) (see Piggot, Robalino, and Jimenez-Martin 2009). One solution to this problem is to reduce subsidies gradually as the beneficiary's income increases using a gradual "claw-back" or taper. This would create a lower EMTR spread over a range of incomes instead of a high EMTR affecting only one specific point in the income scale. Calculations for Chile suggest that optimal claw-back rates should be set at less than 50 percent of marginal income. However, in designing such schemes, policy makers also need to take into account the costs of the targeting system and the possible credibility problems for the system that can be created by targeting errors.

*Ex ante versus ex post transfers.* Transfers that are targeted to workers with limited savings capacity to subsidize their access to SI for pensions, unemployment benefits, and health care can take the form of ex ante matching contributions (to top-up the required premiums to a level sufficient to attain the targeted benefit level) or of additional ex post non-contributory benefits (to top-up purchased or earned benefits to the targeted minimum level of income). Social pensions are an example of an ex post benefit. Similarly, for unemployment benefits, governments might consider matching workers' contributions to UISAs (ex ante) or might pay them subsidized unemployment benefits when their savings in the UISAs run out (ex post). However, in health, as argued above, there is a strong rationale for *ex ante* subsidies. To ensure that liquidity constraints do not prevent timely access, the costs of services should be prepaid, rather than reimbursed to the user.

In principle, ex ante transfers tend to produce better incentives to contribute and may cost less than ex post transfers, at least in the case of pensions and unemployment benefits. The offer to match contributions to pension funds might persuade workers in the informal and agricultural sectors to enroll and save, thus reducing the costs of social pensions in the future.

Simulations done with nonbehavioral models suggest that (depending on the elasticity of the take-up rate to the availability of matching contributions) the use of matching contributions could cost up to 20 percent

less (in present value) than ex post-funded social pensions (see Palacios and Robalino 2009). Behavioral models<sup>12</sup> suggest that moving from a minimum pension guarantee to matching contributions could increase contribution densities while reducing fiscal costs considerably (for a discussion of the case of Brazil, see Robalino et al. 2008). For unemployment transfers, the main advantage of the matching contributions approach is that they give workers an incentive to work. If workers can keep the subsidies to their U.S. account regardless of whether they become unemployed, periods of unemployment might be shorter, and a system based on matching contributions therefore might cost less.

Unfortunately, there has been only limited international experience with ex ante transfers. Some countries, such as China and India, have implemented matching contributions for pensions, but these initiatives have not been evaluated and little is known about the key parameter, the elasticity between the level of matching and the take-up rate. The only rigorous evidence comes from 401(k) plans in the United States, where matching contributions have been shown to increase contributions to voluntary pension plans. These results, however, cannot be extrapolated plausibly to the informal and agricultural sectors in middle-income and low-income countries. No country has yet implemented ex ante UI transfers. The closest examples are the Korean UI system, in which workers who find jobs before their unemployment benefit entitlement ends can reclaim part of the balance, and Chile, where workers may claim an extra month of unemployment benefit after returning to work, but the impact of this policy on the length of periods of unemployment has not been studied.

Nevertheless, the potential fiscal and efficiency gains from using ex ante subsidies to help low-income workers to complete the cost of SI premiums are significant, so the experiences of those countries that are implementing such programs should be monitored and evaluated. Governments in LAC should consider implementing pilot programs of ex ante subsidies, and donors should consider financing impact evaluations of these pilots, given the externality associated with having reliable information about their performance.

***Financing mechanisms.*** The two main options for financing redistributive programs are payroll taxes and the general budget. The general budget is financed by taxes (including value added tax [VAT], consumption, income, and trade taxes) or income from the exploitation of natural resources. Some countries (such as France) use earmarked taxes to finance social security. Such earmarks, however, create rigidities in the budget that can reduce the efficiency of public expenditures. So the basic

financing choice is between payroll taxes and social security contributions, on the one hand, and general revenues on the other.

As discussed in chapter 1, the problem with using payroll taxes to fund subsidies for other workers is that they increase the tax wedge above the amount that is needed to cover the SI of the worker in whose name they are being levied. Tax wedges are high in several LAC countries and can reduce employment and encourage informality. For this reason, a better option would be to finance transfers through general revenues. It is also important to understand the opportunity cost of the resources involved. Given the macroeconomic constraint on total fiscal expenditure, implementing a large income transfer program, for example, might require the government to spend less on education, health, or infrastructure. Such opportunity costs merit careful attention from policy makers.

### **Making Social Protection Programs More Coherent**

The third challenge is to make SI more coherent by integrating or at least harmonizing parallel programs, exploiting opportunities to share savings and insurance pools between risks, and coordinating policies between distinct SI programs and among insurance, social assistance, and labor market programs. This section makes some suggestions about how to advance this agenda. It looks first at measures to increase the internal coherence of SI by harmonizing benefits packages and simplifying and unifying institutions and programs. It then discusses opportunities to develop links between different types of SI (such as pensions and UI) and opportunities to improve the interactions among SI programs, safety net programs, and ALMPs. This second level of integration would have the following advantages: (1) it would reduce costs by sharing an individual's savings pools across risks (such as unemployment and old-age income security); (2) it would avoid adverse interaction effects between SI programs; and (3) it would exploit positive spillover effects between programs.

***Integrating or harmonizing parallel programs.*** In terms of *institutional organization*, the recommendation of this report is that countries should seek ways to rationalize multiple programs and move toward integrated pension, unemployment benefit, and health insurance systems. This could be done as part of the exercise of redefining the mandates of the various systems. Even when full institutional integration is not possible, more limited harmonization can go a long way toward improving equity, increasing efficiency, and reducing costs. Regardless of which institution manages

the programs, similar benefits packages should be offered to everyone, similar financing mechanisms should be used, *and* the same integrated system of subsidies should operate. In essence, subsidies financed out of general revenues would be allocated to top-up the contributions or benefits of individuals with limited savings capacity *regardless* of what program they are enrolled in.

If the goal is limited to *horizontal integration* (that is, the integration of schemes that cover the same risk), one possible strategy to achieve this in the long term is to mandate new generations of workers to enroll in a common insurance system to cover the basic, mandatory programs, while allowing complementary occupational plans to exist on top of them. Meanwhile, policy makers could harmonize benefit formulas and eligibility conditions across programs. Developing arrangements to make benefits *portable* across schemes would be a sensible short-term measure that would be unlikely to encounter resistance from stakeholders. An example is the 1996 Caribbean Community (CARICOM) social security portability agreement, which facilitated labor mobility both within countries and across countries in the Caribbean regional labor market.

***Sharing savings across risks.*** The economic and welfare benefits that can result from integrating SI programs are important. The integration of the self-insurance (savings) component of programs can reduce the total amount of savings needed to provide a given level of insurance, compared with having separate programs. Therefore, common savings funds can increase welfare (Orszag and Stiglitz 1999).

One example of pooled savings is the integration of unemployment benefits and pensions. The rules of most UISAs allow any unused balance in a worker's individual account to be applied to help finance his or her pension on retirement; this is a natural feature of their design. The inverse transaction, however, in which during a person's working life, surplus pension wealth can be used to finance unemployment benefits, normally is not allowed.<sup>13</sup> Yet using pension wealth to cover short-term risks can help workers better manage risk throughout their life cycles and reduce their contribution rates. If the rules allow surplus pension wealth to finance benefits, then for any given level of unemployment benefits, employees and employers can contribute less and the government can subsidize less.

This idea could be operationalized in countries with UISAs (funded or notional) if they were to allow workers to continue to receive unemployment benefits (up to a limit) after the balance in their unemployment savings account becomes negative and government subsidies run out,

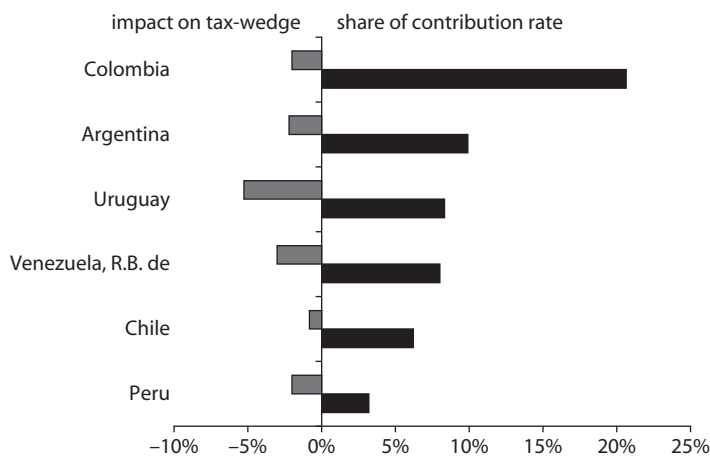
funding this by “borrowing” from their pension account balance. Workers would have two options when they return to work: (1) not to repay the funds, which would imply receiving a lower pension, and (2) to repay the funds through additional pension contributions while still active in the labor market. Clearly, limits would be needed on how much pension wealth could be used, to ensure that enough long-term savings would be preserved to finance an adequate pension (for a discussion of the optimal level of borrowing, see Robalino et al. 2008).

***Cross-effects between insurance programs.*** The performance of any SI program can be affected by the design of other SI programs. An individual’s behavior (such as the decision to work or not, the choice between a formal and an informal sector job, and savings decisions) is influenced by the entire bundle of social security benefits and not just the features of a particular program. So it is natural that the design of one insurance program may enhance or diminish the impact of another. Assessing these interactions is not easy, but they should not be ignored.

The first issue is to specify the bundle of benefits provided by the SI system as a whole. In many countries, this bundle goes beyond core benefits (such as pensions for old age, disability, survivorship and health insurance, and UI), to include family allowances, maternity leave, sick leave, funeral expenses, child care, housing, and ad hoc programs, such as skills training and sports and recreation benefits (as in Mexico and Colombia). The problem is that individuals place different (subjective) values on the benefits included in the bundle. Childless people, for instance, are not interested in family allowances and child-care benefits. Many people are not interested in sports facilities.

When the (subjective) perceived benefit for any contributor of any element in the bundle is zero, the social security contribution that finances it becomes a pure tax on labor income for that person, thus increasing their personal tax wedge. A possible option might be to limit the mandatory bundle to programs that cover social risks for which private arrangements would be likely to fail. This approach would limit the mandate of the social security system to health insurance, pensions (the three types), and unemployment benefits.<sup>14</sup> This would improve incentives and reduce the contribution rate and the tax wedge (see figure 2.4).

Policy makers should be mindful of cross-effects between programs. For instance, a recent study in Brazil shows that the design of the income protection system affects pension contribution densities and retirement ages (Robalino et al. 2008). The reverse is also true: Changes in the

**Figure 2.4 Share of Social Security Contribution Rate Allocated to Nonessential Benefits**

*Source:* Authors' calculations.

*Note:* Nonessential benefits are those that are not related to pensions, unemployment insurance, and health insurance.

pension system can affect contribution densities in the income protection system, take-up of benefits, and, ultimately, fiscal expenditures. The cases of disability and unemployment benefits in Argentina and Chile are also telling. If each system is not designed with the other in mind, then leakages can occur, with individuals recurring to disability benefits when labor demand falls. The weaker the institutional capacity to control eligibility for disability pensions, the more prone the system will be to abuse (see chapter 7 in Ribe, Robalino, and Walker, forthcoming).

***Cross-effects between insurance and other programs.*** Potential gains can be made by coordinating SI and ALMPs and SI and social assistance programs.

Income protection benefits can give people an incentive to participate in ALMPs and labor market intermediation (job and worker search) services. This, in turn, helps intermediation programs to reach the critical mass of participants that they need to be viable. Employers will participate only if the pool of potential candidates is large, and job-seekers will participate only if the pool of potential job offers is large. At the same time, the provision of job search assistance and training and retraining can reduce moral hazard in the unemployment benefit system by ensuring that beneficiaries invest their time in activities that will help them to get a new job.

The main issue regarding the interface between social assistance and SI programs is to coordinate the design and implementation of transfers in the context of *dual* redistributive systems. The first layer would feature a general social assistance system acting as a safety net for *all* poor people. The second layer would include redistributive programs that would make the redistributive transfer conditional on beneficiaries participating in the social security system. For this dual system to work, policy makers would need to calibrate transfer amounts. If noncontributory antipoverty programs were too generous, then this would reduce incentives to participate in social security. On the other hand, if SI subsidies were too high or were available to the non-poor as well as the poor, they could be regressive (see chapter 7 in Ribe, Robalino, and Walker, forthcoming).<sup>15</sup>

### **Deepening Safety Nets and Facilitating Access to Better Jobs**

The objectives of any SP system include preventing poverty and promoting human capital investments and increasing earnings opportunities, thus increasing the savings capacity and reducing the vulnerability of, in particular, low-income young people, unskilled workers, and the poor. Targeted antipoverty programs have a key role to play in this agenda. Many countries in LAC have strengthened safety net transfers in recent years, through instruments such as conditional and unconditional cash transfers and workfare programs. In addition to ensuring a minimum income level for the poorest households, CCTs also seek to enhance human capital outcomes. They will continue to play a key role in overcoming the liquidity constraints faced by the poor while promoting investments in human capital. Also, in the long run, more employment opportunities could be created by improving labor laws, lowering labor costs (by reducing payroll taxes), and improving the quality of education (which is outside the scope of this report). Such changes, however, can take a long time to materialize. In the short and medium term, policies and programs should facilitate *labor force mobility*, increase the *employability* of unskilled workers who are already in the market, help new entrants acquire more and better skills, and reduce *job search constraints* to improve the match between the available supply of and demand for skills.

To facilitate *labor force mobility*, policy makers should consider moving away from severance pay toward unemployment benefits and giving firms more flexibility in their human resources management. Workers need better income protection in the face of involuntary unemployment and

more support to switch jobs or learn new skills and adapt when technological progress makes their current jobs redundant. These goals can be met by UI systems that include retraining and job intermediation programs. These systems can also help to control the inevitable moral hazard implications involved in the option to receive income while not working. As is already done in many OECD countries, benefit claimants would be required to be proactive in seeking work or to participate in training to increase their employability, as a condition for getting income support. International experiences suggest that employment services are among the most cost-effective ALMPs (Betcherman, Daysal, and Pagés 2004).

Evidence suggests that well-designed and targeted ALMPs can increase the employability of low-skilled workers, reduce their job search constraints, and protect them during downturns. Factors that can limit their employability include *technical* and *nontechnical skills mismatches*. Job search constraints, on the other hand, are related to factors that limit the exchange of information between workers and potential employers. They thus involve *information and access* as well as *signaling problems* and also can be related to an insufficiency of the human, social, or physical capital required for successful self-employment. In addition, *transitory* cyclical fluctuations in investment and output and shocks, resulting from technological change or demographic transitions, can reduce labor demand and justify government interventions. Table 2.1 summarizes appropriate programs that address each of these market failures.

**Table 2.1 Employment Barriers and Potential Corrective Measures**

<i>Employability constraints</i>	
Technical skills mismatches	Access to vocational training services On-the-job training, internships, and work experience programs Develop training sector Coverage in hard-to-reach areas and population
Non-technical skills mismatches	Access to general and life skills training services Develop school- and non-school-based programs
<i>Job search constraints</i>	
Job matching	Intermediation through job centers and employment offices Financial assistance for job search
Signaling	Equivalency education programs Skills certification mechanisms (e.g., National Qualification Frameworks)
Capital constraints for the self-employed	Entrepreneurship and self-employment schemes Start-up grants and loans

*Source:* Ribe, Robalino, and Walker, forthcoming, chapter 5.

This report recommends that income protection and ALMPs should be integrated into a labor market risk management system (LRMS). The LRMS would include standard *horizontal interventions* that are needed in all countries and economic environments, serving all workers, as well as *vertical interventions* that target particular groups at risk, such as low-income young people and the poor.

This section laid out general principles for ways in which LAC's policy makers could reform SP systems to expand coverage and better realize their three core functions: smoothing consumption, preventing poverty, and promoting human capital development. Chapter 3 explores the implications for each type of SP program, including pensions, health, UI, ALMPs, and safety net programs.

## Notes

1. For earlier definitions of social protection, see Ehrlich and Becker (1972). See also Holzmann and Jorgensen (2000) for a discussion of the social risk management framework and de Ferranti et al. (2000) for a discussion of the comprehensive social insurance framework.
2. Idiosyncratic risks are those that might affect any individual or household in a given risk group but that only materialize for some of them. Illness and unemployment are cases in point.
3. This study deals with access to jobs but not to credit.
4. Voluntary savings and insurance that aim to complement the coverage in mandatory systems through private arrangements—the so-called third pillar—are not dealt with in this report.
5. As analyzed in the comprehensive social insurance framework developed by Ehrlich and Becker (1972), the optimal choice between savings and risk-pooling depends on the size and probability of the risk. In general, the higher the probability of an event and the lower its expected cost, the greater the inclination toward savings and vice versa. Thus, individuals could save to finance pensions and unemployment benefits, but the high cost and low probability of some extreme health events argues for risk-pooling.
6. When social security contributions finance redistributive SP programs, at least part of the contribution can be considered a tax.
7. It can be argued that earmarked taxes are part of general government revenues.
8. This proposal, therefore, is distinct from the idea of eliminating contribution-based SI systems and moving to tax-based financing of SI systems. The drawbacks of this idea in LAC are discussed in box 2.1.

9. See Perry et al. (2007) and Levy (2008) for a general discussion and Baeza and Packard (2006) for an application to health.
10. In a funded system, the savings amount should be chosen taking account of these factors. In the case of a pay-as-you-go system, given the targeted replacement rate, policy makers must set the contribution rate accordingly.
11. They could eliminate accumulated imbalances only if contributions were to be set above the value of benefits for the present-day contributors, which is not recommended here. If “acquired rights” are preserved when a reform is implemented to rebalance contributions and benefits, the government should acknowledge this (for instance, by issuing nontradable bonds to the pension institution to be gradually repaid from general revenues). Unfunded liabilities of employers also can be included in severance pay systems. If the government mandated a switch to unemployment savings accounts that included these historical liabilities, this could be costly for employers (Kugler 2005). Such acquired rights could be “grandfathered,” however, so that only new benefits would accrue in the savings accounts.
12. Behavioral models are those that take into account the predicted responses of workers to the incentives in the insurance system.
13. An exception is Mexico where unemployed workers can withdraw from their individual pension accounts either 10 percent of the balance or 75 days’ worth of salary, whichever is the lower amount, but the pension account is not connected to the unemployment savings accounts. Moreover, this type of withdrawal can take place only once every five years.
14. Benefits such as family allowances, which are pure transfers and do not involve risks, would be removed from the bundle. Such transfers might have a role in assisting large low-income families, but they should be integrated with other targeted transfers in the social assistance system and financed out of general revenues.
15. This point relates to dual systems where social insurance coverage is not universal and financing is from a combination of user contributions and tax-funded subsidies. In contrast, universal, tax-funded insurance systems can be progressive from a distributional point of view, but—as argued in box 2.1— they may face difficulty in establishing adequate mandates.

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## CHAPTER 3

# Implications for Social Protection Programs

This chapter summarizes the main recommendations that flow from the conceptual framework and the general approach to reform for the main types of SP programs in LAC: pensions, health, unemployment benefits, active labor market programs (ALMPs), and safety net (income support) programs.

### **Pensions**

A mandatory pension system can be organized in different ways, depending on how risks are distributed (defined-benefit [DB] versus defined-contribution [DC] systems), how the financing mechanism is set up (pay-as-you-go [PAYG] or funded), and the type of institutional organization (centralized versus decentralized or public versus private). Regardless of the choices made, the system needs a strong link between benefits and the contributions made during the accumulation phase, while improving the management of risks, devising explicit redistributive arrangements to cover individuals with limited savings capacity, and reducing system fragmentation.

### ***Contributory Systems***

For countries with DB systems (Argentina, Brazil, Ecuador, Guatemala, Haiti, Honduras, Nicaragua, Paraguay, and República Bolivariana de

Venezuela), the first challenge will be to adjust benefit formulas and eligibility conditions to remove implicit redistribution, improve incentives, and restore financial sustainability.<sup>1</sup>

If properly designed, DB-PAYG systems can be viable and sustainable over the long term, even when the population is aging. They also can play an important role in diversifying financial and labor market risks within the pension system, whose importance has been highlighted by the recent financial crisis (Dorfman, Hinz, and Robalino 2008). In most cases, however, benefit formulas and eligibility conditions need to be revised so that everyone receives the same rate of return on their contributions and the rate of return is sustainable.<sup>2</sup> This could be achieved in two ways. The first would be to keep DB formulas but to calculate the accrual rate<sup>3</sup> as a function of the contribution rate, the retirement age, life expectancy at retirement, and expected inflation—while also including all salaries in the calculation of the pension, which should be indexed by the sustainable rate of return of the system.<sup>4</sup>

The second option would be to move to a DC formula but without changing the financing mechanism. This is the so-called notional defined-contribution (NDC) system.<sup>5</sup> This type of system—which has been introduced successfully in several European countries, including Sweden, Poland, and Latvia—tracks contributions and credits an interest rate equal to the sustainable rate of return of the system. When the worker retires, his or her total contributions plus interest (which is notional since the contributions are not invested in financial assets) are transformed into an annuity.<sup>6</sup> Either of these options would ensure that all individuals would receive the same rate of return on their savings. These arrangements would be likely to increase incentives to enroll and contribute in the SP system, since each contribution would count toward the value of the final pension.

In all countries, it is important to continue improving incentives to enroll, particularly for small and medium-size enterprises and the self-employed. This improved enrollment would involve removing any legal constraints that might be preventing the enrollment of these groups. It also would involve interventions to improve the quality of services and to facilitate affiliation and payment of contributions, for example, by allowing workers to contribute flat rates (as opposed to a percentage of their earnings). Finally, it would be necessary to make contribution schedules more flexible—to accommodate seasonal fluctuations in income—and to remove any tight restrictions on vesting periods.

In terms of security, in the case of both DB and DC systems, indexation policies are important. The goal should be to remove discretion in

adjusting the value of pensions to compensate for price increases. The simplest way to do this would be through the indexation of benefits, so long as the inflation rate remains within a band to be specified by the monetary authorities. Only if inflation were to rise above the target range, as a result of unforeseen shocks, would the automatic indexation be suspended and adjustments negotiated between the government and plan members.

Finally, in the case of DC-Fully Funded (FF) systems, the recent financial crisis has emphasized the need to reduce the extent to which plan members are exposed to financial risks. Reducing risk could involve both the implementation of default low-risk portfolios for individuals close to retirement age and more flexible arrangements for the payout phase. These are complex technical issues that go beyond the scope of the present study; a comprehensive review of the options can be found in Impavido, Lasagabaster, and Garcia-Huitron (2010).

### ***Redistributive Arrangements***

Retirement income transfers, such as social pensions, need to be integrated with minimum pension guarantees within the contributory system. This would mean that everyone—whether in or out of the system at a given point in time—would be eligible. The transfer, however, would be means-tested on the basis either of the value of the contributory pension or of the worker's broader means (using, for example, a proxy means test). In either of the two cases, governments could reduce the transfer gradually as the person's income increases (in other words, adopting a gradual claw-back of the transfer) to reduce EMTRs.

When setting the level of benefits and the eligibility age, policy makers should avoid creating negative incentives and should control costs. Benefits set at the equivalent of 15 to 25 percent of economy-wide average earnings would be within the international norm. It also is important to enable the eligibility age to rise in line with increases in average life expectancy to contain fiscal costs.

Several open questions remain unanswered. One question is how to coordinate the design of social pensions with the designs of other social assistance programs. When the latter are well developed, policy makers can make valid arguments in favor of broadening eligibility to include the elderly, instead of developing special programs for noncontributory pensions. Another issue is whether to use ex ante transfers (matching contributions) to stimulate the long-term savings of low-income workers to

reduce the long-term costs of social pensions. Policy makers should pilot and evaluate this type of program.

### ***Institutional Organization***

Horizontal equity and economic efficiency can be increased by making benefits more portable and by harmonizing the benefit levels of parallel plans. Portability is intrinsic to DC systems but also is feasible in DB systems as long as the DB formula is designed so that, at any point of a worker's life, their implicit pension wealth can be calculated and transferred to another system. Several promising approaches have been tried in LAC countries, including (1) an effort to facilitate portability in the Caribbean, (2) the harmonization and coordination of civil servant schemes in federal countries like Brazil and Mexico, and (3) the integration of contributory advance funding schemes and the noncontributory programs in Chile. Related to this, some countries (such as Brazil) have different benefit formulas within the same scheme and could consider adopting a single formula that respects these principles.

### **Health**

The fragmented health systems of most countries in LAC are distant from securing the goals of improving health outcomes and protecting people against the financial consequences of ill health. The coverage of contributory SHI and the proportion of LAC's health costs covered by pooled, prepaid financing are both low. In most countries, access for poor people to good quality basic services is deficient because they can receive only limited benefits from subsidized systems. A further problem is that in all types of health systems, purchasing arrangements are inefficient.

To address these problems, interventions are needed at three levels: (1) rationalizing contributory systems (SHI); (2) expanding subsidized schemes using financing arrangements that are sufficient, transparent, and progressive and that avoid distorting labor market incentives; and (3) improving institutional coherence to facilitate purchasing arrangements that increase efficiency.

### ***Contributory SHI***

The low coverage of contributory SHI is an important factor limiting the pooling of health expenditures in much of LAC. Most countries

include contributory SHI systems in their SI system, sometimes integrated with pensions, and sometimes as stand-alone programs. Policy makers should review financing mechanisms for SHI to ensure financial sustainability, improve equity, and facilitate access of informal sector workers to the system. SHI systems generally base workers' and employers' contributions (*premia*) on income, not on the cost of the insurance. As discussed in chapter 1, many LAC SHI systems lose money, even on their relatively well-paid existing insured population, and they require public subsidies to cover this gap. Such external subsidies to cover global deficits in SHI systems that serve the non-poor are highly regressive. One way to address this issue is to increase contribution rates. However, if some workers have to pay more than they think the service is worth, the tax wedge could rise, with negative effects on formal employment. An alternative option is to base employers' and employees' contributions on the cost of the health plan, rather than on earnings, and to use public transfers to top-up the contributions of workers with earnings below a given threshold. This would facilitate the expansion of the system to include workers in the informal sector. Alternatively, countries may move toward a general-revenue-financed universal basic package, with the contributory SHI system evolving into a voluntary plan, providing additional benefits beyond the basic package. Establishing cost-based SHI contributions would help accommodate the definition of voluntary contributions at different levels.

### ***Subsidized Programs***

As discussed in chapter 2, the region has two types of programs for those excluded from contributory SHI: NHS and noncontributory SHI programs. The main challenges for these programs are (1) improving the adequacy of the benefits; (2) eliminating implicit rationing mechanisms; and (3) improving their integration with the contributory SHI systems.

An important challenge for improving benefit adequacy in subsidized systems (especially NHS systems) is to make explicit the per capita cost of the basic package. LAC governments may need to mobilize additional resources through budget reallocations or higher income or consumption taxes. The development of *partially subsidized* systems together with reforms to reduce subsidies and the tax wedge of contributory SHI systems could help to facilitate this process and to improve the integration of subsidized health insurance with contributory health insurance.

### ***Institutional Coherence***

The fragmentation of LAC's health systems is an understandable outcome of the region's history, but it is not a sustainable situation. LAC governments face considerable pressure to develop a more sophisticated universal mandate and make it effective by improving the scope and quality of noncontributory systems. Such pressures are reflected, for example, in Chile's *Auge* system and in Peru's Universal Health Insurance Law passed in 2009 as well as in court decisions eliminating the differentiation between the rights of poor users and those of contributors to SHI systems (for example, in 2008 in Colombia).

But under current financing and redistributive arrangements, if the mandates and service quality of the noncontributory systems begin to approximate that of SHI systems, the "self-selection" mechanisms that historically have limited the demand for NHS services and noncontributory health insurance programs may begin to break down, and more workers might try to avoid contributing to SHI, because of the availability of similar quality noncontributory systems.

To make it feasible to move toward a uniform package of health entitlements for all and achieve efficient access to pooling of health costs, most health systems in LAC will need to address two structural challenges: (1) promoting coherence, so that care for different population groups is not provided under different rules, which undermines *equity* and distorts *labor market incentives*; and (2) separating financing and provision, which often are vertically integrated within the same entity, thus undermining *efficiency*.

- *Promoting coherence* means ensuring that everyone has access to the same basic package of services (mandate), including their rights to benefits, access to services, quality, cost, and the extent of financial protection, regardless of which system covers them and how it is financed. Moving toward greater coherence will require simplifying revenue collection and adopting subsidy arrangements that reduce labor market distortions.
- *Separating functions*: Within each fragment of the system, the functions of *financing* and *producing* services should be separated. When financing agents are at arm's length from providers, they can induce and reward increases in efficiency. Separating financing and provision within parallel SHI and NHS systems opens up opportunities to virtually integrate provider networks, reducing duplication and optimizing capacity utilization.

In recent years, too little attention has been paid to the challenge of promoting greater coherence. Reform efforts have focused mainly on *expanding coverage* by creating special programs for the poor. Often, these reforms have further fragmented SHI and NHS systems into multiple schemes and programs that have been operated by different organizations under competitive or decentralized delivery models. As a result, LAC now has a growing awareness of the importance of tackling fragmentation and associated equity issues.

Reform cannot follow a simple blueprint. The complex reality of LAC's health systems calls for an undogmatic approach that promotes a gradual transition toward the desired outcomes from diverse points of view. Nevertheless, these basic principles can be useful for navigating toward the goal of universal coverage and improved efficiency for all system configurations.

## **Unemployment Benefits**

The recent financial crisis has underlined the need to rethink income protection systems and to expand their coverage. Some LAC countries have implemented systems based on risk-pooling (UI) and/or savings arrangements (UISAs). Others still rely exclusively on severance pay (Bolivia, Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua, and Paraguay). In the case of the first group of countries, there is room to improve the design of current systems to improve incentives and increase redistribution and financial sustainability, particularly for those relying on UI. For the second group, it is time to consider introducing new systems, while moving away from severance pay and toward unemployment benefits and modernizing regulations on hiring and dismissal procedures. When assessing options and designing reforms, policy makers could consider the following recommendations.

Unemployment benefits systems should rely less on risk-pooling through UI and more on savings. The problem with UI is that the implicit redistribution within the program can create negative incentives for work (moral hazard), increase the length of unemployment periods, and, *ceteris paribus*, increase the unemployment rate. These negative incentives can be important if UI benefits are extended to informal sector workers. In addition, because low-income workers have lower take-up rates and shorter periods of unemployment than middle-income and high-income workers, UI systems also can be regressive. Unlike in DB pensions, it is difficult to make

UI systems more actuarially fair by linking the cost of expected benefits to contribution rates.

The alternative is to introduce UISAs. As with pensions, UISAs can be FF or PAYG (notional). What matters is that the benefits should be directly proportional to what workers have contributed or saved, thus giving them a strong incentive to work. The system should incorporate explicit targeted subsidies to top-up the savings of low-income workers.

### ***Designing the Savings Component***

As in the case of pensions, policy makers must select the mandate of the system, how benefits are paid (lump sum versus monthly), whether the savings can be used for purposes other than financing unemployment benefits (for example, purchasing a house), and whether individuals can borrow against their future benefit when the balance in their accounts runs out.

Regarding the mandate, in addition to the general principles outlined in the previous section, it is *first* important that policy makers make their choices based on a clear understanding of the nature of unemployment shocks and their impact on earnings. *Second*, given uncertainties regarding how the program will affect workers' behavior, it would be prudent to start with a conservative mandate that could be expanded gradually if necessary. *Third*, policy makers should avoid requiring too high a level of precautionary savings. Workers who accumulate balances in their unemployment account above a given maximum (set by the policy) should be allowed to withdraw their benefits or stop contributing. For example, the limit on savings might be an amount that would be enough to fund six months of benefits at the targeted replacement rate.

In terms of payment arrangements, it is preferable that benefits should be paid out in monthly installments and not in a lump sum. If the focus of the system is on consumption smoothing, in part because of individuals' myopia, there is no justification for paying benefits as a lump sum. Doing so can give workers an incentive to change jobs or move to the informal sector. Moreover, if savings are mismanaged, individuals might not have adequate income protection during their entire period of unemployment.

Unemployment savings (below the maximum capital) should not be used to finance investments or to cover other life events. This could reduce precautionary savings below the level needed to manage unemployment risks adequately. If policy makers perceive the need to promote savings or increase access to credit, they should use other instruments, unrelated to the unemployment benefit system, to make that happen.

The other policy choice is whether to allow individuals to “borrow” from any surplus in their pension account so they can continue to receive benefits when the balance in their UISA accounts is too low to cover the targeted replacement rate or the minimum benefit. This is a good policy because it makes the system more flexible and thus enables savers to manage risk better.

### ***Redistributive Arrangements***

Two important choices to be made are those regarding the vesting period and targeting mechanism. Unlike pensions, where retirement income transfers (such as social pensions) can be provided only on the basis of age (in other words, without having a contribution history), in the case of unemployment benefits, transfers always have to be conditional on having a minimum vesting period. This would be necessary to control costs and provide incentives to enroll and contribute.<sup>7</sup> The longer the vesting period and the higher the savings that individuals accumulate, the lower the take-up rate, and therefore the lower the demand for subsidies, would be. At the same time, vesting periods that were too high would force workers to go through long periods without adequate protection. The choice will have to be determined, in part, by the duration of the subsidized benefit. The longer the duration of the benefit, the longer the vesting period needs to be.

As with pensions, it is important to allocate transfers (subsidies) based on a resource (or means) test. Indeed, for a given level and duration of the transfer, a resource test reduces fiscal costs. For a given budget, it makes it possible to concentrate resources on those who need them the most. Also, as in the case of pensions, governments could consider a gradual claw-back rate of the benefit to reduce implicit marginal tax rates.

The question is also open about whether to use *ex ante* or *ex post* transfers. In principle, *ex ante* subsidies can give workers an incentive to work and can reduce the economic cost of the system. No programs of this kind yet exist in LAC, but governments might consider piloting them.

### **Active Labor Market Programs**

In the context of the labor risk management system discussed above, countries will need to reassess active labor market programs (ALMPs). The starting point is to understand the problems of employability and job-search constraints, which ALMPs seek to address. These problems

often coexist, which calls for integrated interventions including training, employment services, skills recertification, income support or wage subsidies, and programs to support the self-employed. Successful implementation will require improving governance, administration, and monitoring and evaluation systems. It is important to avoid excessive centralization, to give local offices managerial flexibility, and to identify opportunities to outsource implementation to public and private companies through contracts that reward performance. This implies building capacity to manage the bidding process for the selection of training centers and program providers. It is also important to build institutional capacity. For instance, strengthening the coordination of multiservice programs can reduce operational costs. Finally, improving monitoring and evaluation systems is critical for better planning and decision making. Programs need to be adjusted and optimized continuously, and this can only be done if real-time data are available about their operations and performance. Some of the main design issues for these programs are summarized in the following sections.

### ***Training Programs***

Training programs should include on-the-job training to enable trainees to acquire skills and competencies in a variety of settings. In the case of low-income workers, the programs could provide trainees with stipends, reimbursement of fees, transportation vouchers, and financial assistance throughout the duration of the program (these could take the form of wage subsidies). It is also critical to ensure that the training focuses on skills that are in strong demand and for which there are shortages in the labor market. One way to achieve this is by requiring potential training providers to submit to competitive bidding. Good examples of these programs can be found in Brazil (PLANFOR), the Dominican Republic (*Juventud y Empleo*), and Panama (*Procajoven*). At the same time, it is important to have the cooperation of prospective employers, which might require the use of wage subsidies.<sup>8</sup>

Given limited resources, these programs should be targeted to the most vulnerable population groups. Most *Jóvenes* programs in Latin America have at some point organized a massive campaign advertising the training courses in all municipalities. Thereafter, the process of selecting beneficiaries began with interested young people approaching the local employment offices where they filled in a targeting questionnaire or were interviewed to determine their socioeconomic status to

see whether they matched an objectively defined eligibility profile. In some cases, the young people went through both the questionnaire and the interview.

### ***Employment Services***

The effectiveness of employment services can be enhanced by (1) increasing registration by workers and firms in employment exchanges; (2) improving the quality of the services; (3) extending their regional coverage; (4) developing minimum performance standards that can be specified nationally but then adjusted to local constraints; and (5) linking them with other ALMPs and making their use a condition of the receipt of benefits (in those countries that offer income protection). These services should extend their reach into the informal sector. For example, employment services in Peru provide information to small enterprises in a bid to give them an incentive to register and to join the formal sector.

Overall, these programs need to fully exploit information technology to increase demand and reduce costs. For example, Web sites can be used to disseminate information on workers' rights, employment regulation, the availability of programs, resources for job-seekers, vacancies, and links to sites that advertise vacancies in other countries. It is necessary to provide personalized services to job-seekers and to establish close links with employers. The most productive public employment agencies offer employers such services as managing their vacancies, screening candidates, and providing information on all the programs that can benefit them. The programs should set up a series of one-stop employment centers delivering a variety of services in one location. Finally, the system should promote competition between public and private providers to create incentives to provide the best possible service and to introduce market signals into the system. Public agencies would retain a monitoring role and be in charge of determining the eligibility of participants.

### ***Skills Recertification***

Skills certification is a way to improve matches between demand and supply in the labor market. This certification should be done using a national qualifications framework (NQF)—a single, coherent, and comprehensive instrument for classifying qualifications according to criteria for specified levels of learning. An NQF can integrate and coordinate all national qualifications subsystems and make the qualifications

process better and more transparent in relation to the labor market and to civil society. A successful NQF would achieve the following: (1) describe qualifications in terms of a single set of criteria; (2) rank qualifications according to a single criterion or a single hierarchy of levels; (3) classify qualifications in terms of a comprehensive set of occupational fields; (4) describe qualifications in terms of learning outcomes that are independent of the training site, the form of training, and the type of pedagogy or curriculum offered; and (5) define qualifications in terms of notional learning hours.

### ***Wage Subsidies***

Successful programs can be created if the following criteria are met: (1) subsidies are combined with other services such as skills training and counseling; and (2) subsidies are set at an appropriate level to generate the right incentives and minimize potential side effects. Comprehensive packages of services that combine wage subsidies with other measures (such as training, counseling, and job assistance) tend to have a positive impact on a trainee's labor market prospects, particularly among young people. The design of this extended package of services is crucial for the success of the program.

The other critical aspect is proper targeting and wage-setting strategies. The idea is to target these programs to disadvantaged people who otherwise would be unemployed, thus reducing substitution effects and "dead-weight" losses.<sup>9</sup> In general, the programs would target low-income workers and unskilled young people.

### ***Support for the Self-employed***

Few programs provide services to support the self-employed in the region and more are needed. The key design and implementation features of such programs include the following: (1) disseminating information about the programs through large advertising campaigns (this is particularly necessary to reach low-income individuals or those with few skills who tend to be less well informed than others); (2) establishing an independent panel composed of successful entrepreneurs, university professors, and specialists to select business plans that have the potential to be profitable and feasible; (3) providing advisory services, particularly for low-skilled workers, to help applicants prepare their business proposals; and (4) providing training and post-business creation

services to potential entrepreneurs. It is important to ensure that would-be entrepreneurs (at least those whose proposals are selected) receive some training in general management skills. Once the selection panel has approved a proposal, project managers need to continue to receive support from these self-employment support programs, including training, counseling, and internships.

### **Safety Net Programs**

As part of the overall development of more coherent SP systems, LAC's targeted income support systems need to be strengthened in four major areas, mainly related to the further development of the successful CCT model: (1) coordinating between CCTs and the supply-side in health and education and between CCTs and the social welfare system; (2) refining procedures for enrolling and "graduating" beneficiaries in a timely fashion; (3) adapting programs to urban settings; and (4) strengthening the crisis response capacity of the programs.

#### ***Supply-side Coordination***

CCT programs need to operate as part of the overall system of social welfare provision. However, ensuring quality health, nutrition, and education services remains a big challenge in most countries in the region. Many governments have taken actions to improve services in communities targeted by CCTs, but much work remains to be done on this agenda. Experience suggests that sector ministries working closely together is fundamental to the success of CCTs and other intersectoral social programs (Levy and Rodriguez 2004). Where CCTs have received high-level political endorsement, they have been instrumental in increasing coordination among ministries and other agencies and in increasing health and education investments in areas in which CCTs operate. Clarifying the roles and responsibilities of the programs themselves, and those of high-level social sector planning agencies, is an essential component of the future development of these systems.<sup>10</sup>

#### ***Enrollment and Graduation***

CCT programs have become an established feature of the LAC SP architecture. They now need to develop more sophisticated mechanisms to incorporate new beneficiaries and "graduate" families that no

longer need long-term income support. This will involve establishing open-enrollment mechanisms so that families that become entitled to the program (for example, because they have had a baby) can apply for support immediately without having to wait for a large-scale recertification exercise. This, in turn, would require the establishment of local offices that can take applications, and the development of sophisticated online databases of program beneficiaries. It should be possible to cross-reference such databases with other social sector information systems to enable those receiving income transfers to access other programs to which they may be entitled (such as free health insurance and labor market access programs).

At the same time, existing beneficiaries should be recertified periodically to ensure that they still meet the demographic and poverty tests for continued participation in the program. Those who no longer qualify should graduate from the program to make room for others. Families that leave because they no longer meet the demographic criteria but that are still poor should be referred to other programs that can provide ongoing support.

### ***The Urban Challenge***

Although urban poverty rates are lower than those in rural areas, many of the region's poor now live in cities. This has generated political pressure to expand CCT coverage to urban areas, as has been done by *Bolsa Família* in Brazil, *Oportunidades* in Mexico, and *Familias en Acción* in Colombia.

The urban environment presents additional challenges for noncontributory income support programs. The social and economic complexity of urban settlements is greater than that of most poor rural communities, with poor and non-poor households living closely together in the same communities. This makes it crucial to complement geographic targeting with instruments that can identify appropriate beneficiary households and exclude the non-poor.

Key differences also exist between the characteristics of urban poverty and those of rural poverty. Basic health and education coverage is normally much higher in urban areas than in rural areas so the need to stimulate demand is lower. Often, the most urgent problems are on the supply side; many health and education services in urban areas already have difficulty expanding supply and improving quality fast enough to keep pace

with population growth and have limited opening hours, making it harder for working people to use them.

On the other hand, the short-term potential for the economic advancement of extremely poor urban households is greater than for poor rural households because of the existence of concentrated labor demand in urban areas. The existence of more work opportunities in urban areas also means that the opportunity cost of households' time is higher. This has led to much lower take-up rates for urban CCTs than generally is achieved in rural areas.

A promising approach for adapting LAC's SP systems to the urban environment is to focus on extending access to the labor market and to earnings opportunities to young people in low-income communities. Increasing earnings potential is the part of the human development agenda that is most clearly in need of strengthening in the region's cities. To further this goal, transfers could be paid in the form of modest job search or training allowances, targeted through self-selection by requiring beneficiaries to participate intensively in training and job search activities. Where demand-side constraints to completing secondary education are evident, CCTs could provide cash incentives to encourage low-income students to complete their secondary education.

It would be useful to define a new role for urban municipal authorities in the provision of SP. In the past, central governments too often simply delegated SP to local governments, which had little fiscal capacity to respond. In recent years, this has been reversed. National SP programs have been developed to target resources on the most vulnerable. In most countries, municipalities have played only a limited role in these national programs. Exceptions include Brazil and Colombia where municipalities play a key role in the registration of the beneficiaries. But across the region, municipal capacity (financial and administrative) has been increased by decentralization, and many large cities have now developed their own SP programs. National governments now need to clarify the role of local governments in SP systems and to take advantage of their capacity to identify local needs in consultation with local communities as well as their ability to cofinance and deliver SP programs, especially in cases in which these local governments have considerable fiscal resources. The use of local structures and financing needs to be coordinated with national SP agencies. This coordination is already happening in Chile where municipalities play a central role in the SP system, in coordination with the national

program *Chile Solidario*, to ensure that vulnerable populations are given priority access to essential services.

### **Strengthening Crisis Response Capacity**

The global economic crisis of 2008–09 has highlighted the importance of strengthening safety nets for the poor. The main message from the crisis is that those countries that have well-structured, long-term antipoverty programs, such as CCTs, can use them as the basis for implementing temporary responses to protect their targeted beneficiaries against shocks such as the 2008 food price crisis, by adjusting benefit levels or eligibility thresholds to offset price inflation. Brazil, Chile, Colombia, El Salvador, Mexico, and Panama all have used their existing program structures as the basis for creating effective—and cost-effective—responses to crises between 2008 and 2010. However, although they have been effective in helping to protect extremely poor households from the food and fuel shocks, CCTs are not an ideal instrument to address reductions in income produced by cyclical fluctuations and they fall short as a response to broader crises that also affect the non-poor. Therefore, policy makers need to give more attention to developing SI, labor market services, and training.

The capacity of core social assistance systems established *before* a crisis hits is crucial to a country's ability to help the poor in times of crisis. This system should include as a minimum, well-established targeting mechanisms, reliable databases of registered households and management information systems, payment and delivery mechanisms, and tools for basic monitoring, oversight, and control. When these elements are in place, benefit levels can be enhanced and the introduction of new programs can be accelerated to offset part of the shock. Even where policies are not immediately adjusted, simply being enrolled in a conditional transfer program can reduce the likelihood that families will respond to income shocks by reducing investments in their children's health and education. When such systems are not in place, policy makers' options for responding effectively to a crisis are far more limited, and they are forced to turn to less efficient interventions such as general food subsidies or temporary workfare programs, which are costly and have a limited impact.

### **Notes**

1. It would be necessary to review benefit formulas, eligibility conditions, and financing arrangements for survivorship and disability pensions. Similar principles would apply.

2. A good proxy for the rate of return on DB pension contributions is the growth rate of the average covered wage (see Robalino and Bodor 2009).
  3. The accrual rate is the share of preretirement earnings that the individual receives for each year of contribution.
  4. For more detailed discussions about how to set benefits formulas and eligibility conditions in earnings-related systems with PAYG financing, see Robalino (forthcoming).
  5. For a description of the systems and for technical analysis regarding their operation, see Holzmann and Palmer (2005).
  6. The value of the pension (annuity) is given by [(total contributions plus accumulated interest)/annuity factor]. The annuity factor depends on life expectancy at the age of retirement.
  7. This vesting period is not necessary in the case of the contributory part of the benefit, which is self-financed.
  8. Programs such as the Employability Improvement Program in Canada and the New Deal for the Young Unemployed in the United Kingdom show that wage reimbursement for employers should be considered.
  9. A dead-weight loss, in this context, is the part of a wage subsidy program spent on workers who would have been hired anyway.
10. See Social Protection Unit, Human Development Department (2007).

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## CHAPTER 4

# The Trajectory of Reform

This report has outlined common challenges in SP for LAC countries and has proposed a common vision to address these challenges. The countries of the region face these challenges from very different starting points, however. These countries vary greatly in size, demographics, economic structure, level and distribution of income, human development indicators, fiscal capacity, government effectiveness and regulatory quality, and the prevalence of informal SP institutions. Such factors determine which policy interventions are viable in the short and medium term and their costs and benefits. In addition, both what *can* be done and what *needs* to be done depend on what already exists. According to this criterion, three broad groups of countries can be identified: (1) *reformers*, which have implemented major initiatives in all SP programs in recent years; (2) *partial reformers*, which have introduced important innovations in some areas; and (3) *nonreformers*, where no major innovations have taken place.

The first group of countries includes Argentina, Brazil, Chile, Colombia, Mexico, Panama, and Peru, which have transformed their pensions, unemployment, health, and social assistance systems over the last two decades. The second group includes Bolivia, Costa Rica, Ecuador, El Salvador, the Dominican Republic, Guatemala, Honduras, Jamaica, Uruguay, and República Bolivariana de Venezuela. Some have reformed

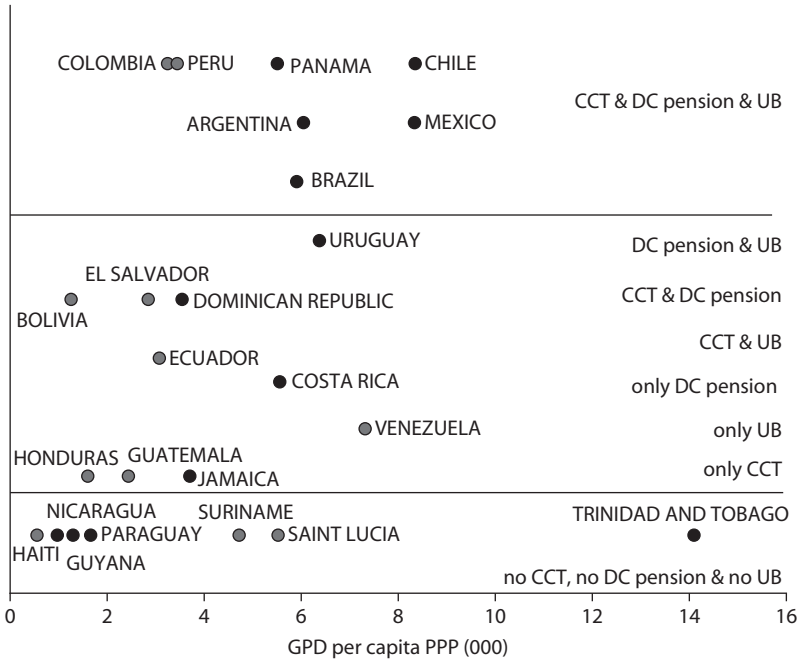
their pension systems, others their UI systems, others their health financing systems, and others their social assistance programs. Finally, in countries like Guyana, Haiti, Nicaragua, Paraguay, and Trinidad and Tobago no major interventions have taken place in the SP system (see figure 4.1 and table 4.1). In this final chapter, we outline reform priorities for each of these groups of countries.

**Reformers**

Reformers are countries with relatively strong institutional capacity and few fiscal constraints to implementing reforms. Their two main challenges are to consolidate current SI programs, while extending their coverage and optimizing the use of antipoverty programs in urban areas.

In *pensions*, in countries with funded DC systems, it is necessary to improve the control of administrative charges, the regulation of workers’ investment portfolios during their transition into retirement, and the

**Figure 4.1 Policy Innovations and Income per Capita**



Source: Authors’ creation.  
 Note: CCT = conditional cash transfers, DC = defined contribution; GDP = gross domestic product; PPP = purchasing power parity, UB = unemployment benefit.

**Table 4.1 Initial Conditions That Affect Reforms**

Countries	Income level	Poverty and/or income concentration	Government effectiveness and regulatory quality	Aging	Infant mortality
<b>Group 1: Reformers</b>					
Argentina, Brazil, Chile, Mexico, and Panama	[5,900–8,400]	+ (Mexico–)	+(Argentina=)	=(Argentina+; Chile+)	– (Brazil =)
Colombia and Peru	[3,300–3,500]	+	+(Peru=)	=	Colombia–; Peru+
<b>Group 2: Partial Reformers</b>					
Costa Rica, Uruguay, and Venezuela, R.B. de	[5,500–7,300]	+(Costa Rica–; Uruguay–)	+(Venezuela, R.B. de–)	=(Uruguay+)	–
Bolivia, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, and Jamaica	[1,300–3,700]	+(Jamaica–)	=(El Salvador+; Jamaica+; Bolivia–)	=(Bolivia–; Honduras–; Guatemala–)	=(Bolivia+; Jamaica–)
<b>Group 3: Traditional Systems</b>					
St. Lucia, Surinam, and Trinidad and Tobago	[5,500–14,100]	+	St. Lucia+; Surinam=	=	St. Lucia–; Surinam=
Guyana, Haiti, Nicaragua, and Paraguay	[600, 1,700]	+	–(Guyana=)	–(Guyana=)	=(Haiti+)

Source: Authors' compilation.

Note: + stands for high, = stands for moderate, and – stands for low.

design of the payout phase. In the two countries with PAYG systems, Brazil and Argentina, it is important to adopt benefit formulas that take into account contributions histories and life expectancy at retirement and to establish transparent subsidy arrangements that make clear what part of the value of pensions is financed by contributions and what part is subsidized. Subsidies should be funded from general taxation and not by implicit transfers between plan members.

In *health*, the main challenges are to extend quality basic health services and financial protection to the whole population and to integrate parallel public SI programs and NHSs to reduce duplication and costs.

In terms of *unemployment benefits*, policy makers have room to improve the design of UI and UISAs, while moving toward more integrated LRMS. Chile has become a leader in this area by changing the balance between the savings and redistribution elements of UI and by implementing innovative programs such as *Jóvenes*. Argentina might consider expanding UISAs to other workers beyond the construction sector. Mexico might consider moving beyond an unemployment benefit system based on individual pension accounts (*Afores*) toward fully fledged UISAs, while preserving the relationship between the two. In Brazil, UI and the UISA system could be integrated. In all of these countries, unemployment benefits need to be integrated with services that offer job search assistance, intermediation, and retraining.

In parallel, governments need to use redistributive subsidies to leverage the expansion of SI. The best place to start is with a review of the noncontributory elements of SI, to integrate them with contributory programs, reduce the tax wedge, and remove incentives for informal sector work. Chile has initiated a second round of reforms in pensions and income protection that go in this direction. Other countries should consider similar arrangements, especially in the area of income protection, which rarely covers informal sector workers.

At the same time, care should be taken when expanding safety net programs into urban settings. For example, the CCT model originally used in rural areas needs to be adapted to take into account urban social and labor market realities. Subsidized UI—coupled with ALMPs to help beneficiaries to find sustainable employment opportunities—is a promising complementary approach.

## **Partial Reformers**

The partial reformers constitute a more heterogeneous group of countries. They include low-middle-income countries (such as Bolivia, the

Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, and Jamaica) that face fiscal and institutional constraints and major challenges to reducing poverty and improving income distribution and human development indicators. One priority for this group should be to create fiscal space by removing any implicit regressive redistribution subsidies from the pension system and then to spend more resources on preventing poverty and increasing the adequacy of health services.

Reforms in *health* are critical. All of these countries (except Jamaica) have fragmented systems with a low proportion of prepaid or pooled expenditures (below 50 percent), and they face concerns about the adequacy of the benefits provided by their NHS. The Dominican Republic is presently undergoing a major health reform that has transformed contributory SHI and introduced a noncontributory insurance scheme with similar benefits.

In the case of *antipoverty* programs, the priority should be to create well-targeted workfare programs in poor urban areas and to expand ALMPs to upgrade the skills and increase the labor market opportunities of the poor and low-income young people. SP policy makers in these countries should avoid the temptation to expand CCTs into urban areas and should concentrate instead on coordinating with the education and health sectors to shore up the supply-side response to the increased demand that CCTs engender.

Costa Rica and Uruguay face somewhat different challenges. They need to complete reforms in SI while expanding their social assistance programs. Costa Rica already has a partially integrated health insurance system, and the proportion of prepaid or pooled expenditures (close to 80 percent) is among the highest in the region. It has addressed the main issues in the contributory pension system (the pending problems are similar to those faced by the reformers). The recently created CCT program is another step in the right direction. Reform of the income protection systems, however, is still pending. In Uruguay, pension reform has been implemented and advances have been made in expanding income support through the PANES program in 2005 and the *Plan de Equidad* since 2008. Historically, Uruguay had a fragmented health system with low levels of prepaid and pooled expenditures. But, in 2007, it embarked on an ambitious health sector reform that aims to achieve universal coverage, including the integration of financing schemes into a single risk pool. Uruguay has room to improve UI, especially by establishing stronger active labor market policies to support claimants in finding work. There is also scope for exploring options to link unemployment savings accounts with pension savings.

## Traditional Systems

The traditional group is the most heterogeneous. It includes both low-income and relatively high-income countries. Among the low-income group (Guyana, Haiti, Nicaragua, and Paraguay), the challenges are many and the constraints, in terms of resources and institutional capacity, are severe.

Even before the 2010 earthquake, Haiti was a special case, and the immediate focus of policy should be to create effectively administered and well-targeted antipoverty programs (transfers and income-generation programs) and to increase access to quality basic services, including health, through the integrated NHS. Given fiscal constraints, the Haitian government needs to control the public sector wage bill and the cost of civil service pensions. The earthquake has redoubled the severity and urgency of these challenges and made it imperative that they should be addressed with large-scale international support.

In Guyana, Nicaragua, and Paraguay, the first priority should be to create well-targeted *transfer programs* for the poor. Nicaragua's poverty rate is among the highest in the region. In Paraguay, it is lower, but the income distribution pattern is worse. In the face of their very low coverage levels for old-age income support, given fiscal constraints and the high concentration of income, these three countries also need *pension reform*. In demographic terms, they are among the youngest in the region, but the low coverage of their pension systems has led to high dependency ratios. Increasing the adequacy of NHS *health* benefits is also an important priority.

In contrast, St. Lucia, Surinam, and Trinidad and Tobago have ample resources and enough institutional capacity to introduce the needed structural reforms within their SP systems. Their demographic structures are similar to Argentina, Chile, and Uruguay, and their unfunded PAYG pension systems are a major threat to their fiscal stability. Trinidad and Tobago stands out. It has the highest level of income in the region, a large industrial sector (and therefore little informality), and low poverty rates. The health system is integrated and, although pooled expenditures are low for the country's level of income (at around 50 percent), the infant mortality rate is among the lowest in the region. In St. Lucia and Surinam, poverty rates are high, and no targeted transfer programs have been created. In addition, the health systems in these two countries are fragmented, and prepaid and pooled expenditures are low.

Overall, however, these countries have the economic and institutional capacity to establish much better and more integrated SP systems. They

need a reform strategy on all three fronts: (1) to tackle the fiscal threat posed by their unreformed pension systems; (2) to meet the income support, labor market, and crisis response and safety net needs of the uninsured poor; and (3) to increase the financing and improve the quality of their health services.

## **The Way Forward**

The current socioeconomic environment in LAC countries is conducive to reforming SP systems. The growing social consensus is that income distribution needs to become more equitable. SP policies can contribute to reversing the trend of income concentration. In addition, the financial crisis has shown that many SP systems were ill prepared to deal with economic shocks that affect large parts of the population. Therefore, there is a growing political demand for reform, and basing these reforms on the idea of more transparent and equitable redistribution could unite different sides of the political spectrum.

In this context, it is useful to separate the discussion of objectives and the general principles that drive a given reform from discussions about implementation arrangements. Social preferences are important at the level of principles, but at the implementation level, it is essential to adopt a pragmatic and technocratic approach to what works and what does not, thus avoiding “universal models” of how programs should be designed.<sup>1</sup> In this report, the emphasis has been on clarifying the objectives of SP systems and outlining general principles and approaches to guide reforms that would enable the countries of the region to extend the coverage and increase the effectiveness of SP systems. The specific policies chosen to achieve those objectives will depend on each country’s initial conditions and priorities.

Without a doubt, the challenges involved in SP reform in the LAC region are complex. The problems laid out in this report will not be resolved overnight, and advances will sometimes be small. What is important, however, is that those small steps should be taken in the context of a clear long-term vision so that they can move the region toward a more coherent, integrated, effective, and equitable SP system in the medium term. The worst mistake would be to implement piecemeal reforms that respond only to short-term concerns and minority interests, uninformed by any long-term strategic vision.

The review of lessons learned from the successes (and failures) with past SP reforms presented in this report aims to provide policy makers

with workable principles on which to base a new phase of reforms to support that goal.

The central ideas are simple. To turn the *right* to SP into a universal *reality*, (1) *contributory SI* should be opened up to informal sector workers on an optional basis with adequate financial and institutional incentives; (2) SI benefits should be aligned with the value of contributions; and (3) subsidies should be transparent, targeted to workers with limited savings capacity, and financed out of general taxation. Wherever possible, SI programs covering different populations or risks should be consolidated and their benefits packages harmonized.

At the same time, *safety net programs* aimed at reducing poverty should be targeted based on poverty criteria and program rules should avoid creating disincentives to work or save. More emphasis should be placed on interventions that *promote human capital* and reduce vulnerability by strengthening links from SP programs to improved health, nutrition, and education outcomes. Policy makers also need to improve the design of ALMPs to help the most vulnerable workers (especially young people entering the labor market and low-income unskilled workers) get better quality jobs and avoid long-term unemployment. Finally, care should be taken to coordinate policies across different types of programs to take advantage of potential synergies and cross-effects and to avoid adopting policies with conflicting aims.

The five key steps toward implementing this agenda are:

- *Open up contributory SI programs to all workers*, regardless of where they work. This means maintaining mandatory insurance in the formal sector but also promoting the inclusion of informal sector workers in contributory SI programs on an optional basis, with adequate financial and institutional incentives.
- *Review the mandates of SI programs*. The objective is to make explicit choices about the coverage and benefits to be offered to individuals with different levels of income. These choices need to be adequate but also efficient and affordable.
- *Make subsidies transparent and progressive*. The idea is to remove implicit taxes and subsidies within SI programs and move toward a unified system of subsidies that are targeted based on means. These subsidies would decline gradually as the beneficiary's income rose and would be financed from general revenues. This would make redistrib-

ution more progressive and avoid distorting incentives for workers and employers.

- *Make SP systems more coherent* by integrating or harmonizing parallel programs and exploiting opportunities to share savings and insurance pools between risks. Policy makers also need to rationalize the interactions among SI, safety net programs, and ALMPs.
- *Deepen the antipoverty social safety net and develop programs to facilitate access to better jobs.* Cash or in-kind transfers are needed for workers and households in extreme poverty who have no capacity to participate in contributory SI, even with subsidies. A key objective is to ensure that these social safety nets encourage poor households to invest in education, health, and nutrition to avoid the intergenerational transmission of poverty. In parallel, ALMPs are needed to help low-income and low-skilled workers increase their employability and to facilitate labor mobility and job search. This can increase their earnings and reduce their economic vulnerability, thus relieving pressure on other elements of the SP system.

## Note

1. See Santiso (2006) for a discussion of the importance of pragmatism in the successful reforms in Brazil, Chile, and Mexico.

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# Glossary

**Accrual rate:** Percentage of salary to be paid as a pension accrued for each year of contribution.

**Active labor market program (ALMP):** Initiative aimed at increasing the skills, employment, and long-run earning potential of participants through training, apprenticeships, job search assistance, subsidized job placements, and the like.

**Contribution density:** Share of earnings in the active phase of life on which the individual contributes to some contributory pension system for old age.

**Contributory programs:** Plans under which the employee is required to pay part of the cost either for participating or for increased benefits, generally done through payroll deduction.

**Defined benefit:** A pension plan with a guarantee by the insurer or pension agency that a benefit based on a prescribed formula will be paid. Such plans can be fully funded or unfunded.

**Defined contribution:** A plan in which the periodic contribution is prescribed and the benefit depends on the contribution plus the investment return on accumulated contributions.

**Effective marginal tax rate (EMTR):** Discussed in the context of government transfers. Gives the percentage loss in the value of a subsidy resulting from an increase in total earnings or contributory benefits.

**Fully funded plans:** The accumulation of pension reserves that total 100 percent of the present value of all pension liabilities owed to current members.

**Implicit pension debt:** The present value of pension rights (among contributors and retirees) accrued to date.

**Informal:** Sector of the economy that includes a wide range of unregulated economic and extralegal activities, generally involving work for pay that does not come in the form of wages, and employment conditions that are not regulated by local, state, or national governments.

**Internal rate of return (IRR):** Used in the report in the context of pensions. It is the discount rate that equates the present value of contributions with the present value of pensions.

**Mandate:** An official order from an authority to implement an action.

**Mandatory:** Required or commanded by authority.

**Noncontributory programs:** Relating to a pension plan in which participating members or employees are not required to support the plan with their own contributions.

**Notional defined contribution:** A scheme in which benefits are determined by the accumulation of contributions and notional, legislatively defined “interest.”

**Pay-as-you-go:** A method of financing in which current outlays on pension benefits are paid out of the current revenues from an earmarked payroll tax.

**Pay-as-you-go asset:** Discussed in the case of pay-as-you-go pensions. It is the present value of future contributions net of the pension rights accruing from those contributions. In a solvent pay-as-you-go system, the pay-as-you-go asset plus any disposable financial assets should be equal to the implicit pension debt.

**Replacement rate:** Ratio of pension benefits to average wage.

**Risk-pooling:** Collection and management of financial resources in a way that spreads financial risks from an individual to all pool members.

**Social assistance:** Income-tested cash benefits targeted to poor households.

**Social insurance:** Contributory programs designed to help households insure themselves against sudden reductions in income. Types of social insurance include publicly provided or mandated insurance against unemployment, old age (pensions), disability, the death of the main provider, and sickness.

**Social protection:** Set of public interventions aimed at supporting the poorer and more vulnerable members of society, as well as helping individuals, families, and communities manage risk. Social protection includes safety nets (social assistance), social insurance, labor market policies, social funds, and social services.

**Social safety net:** Noncontributory transfer programs targeted in some manner toward the poor and those vulnerable to poverty and shocks.

**Take-up rate:** The proportion of those entitled to a benefit that actually claims it.

**Targeted programs:** Initiatives for which a special effort is made to focus resources among those most in need of them.

**Tax wedge:** Difference between the cost of labor to the firm and the worker's net remuneration or take-home pay.

**Unemployment individual savings accounts (UISAs):** Unemployment benefit system in which individuals (and employers) are mandated to contribute to funded individual accounts. Savings accumulated in the accounts can be withdrawn in the case of job loss.

**Vesting period:** The number of years or months of contributions necessary to qualify (vest) for benefits.

**Voluntary:** Nonmandatory.

**Zero pillar:** Noncontributory social assistance financed by the state.



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