

FROM RIGHT TO REALITY

Achieving Effective Social Protection for all in Latin America

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Acknowledgements

This summary report is based on “From Right to Reality: Extending Effective Social Protection for All in Latin America by Adapting Programs to Labor Markets and Rationalizing Redistribution” (Robalino, Mason, Ribe, and Walker, 2009, forthcoming), a regional study 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. The main study contains detailed chapters on recent trends in SP systems in LAC, the operation of the region’s labor markets, old age income support, health, safety nets and active labor market programs, and the interactions between elements of the SP systems. The full *study team* included Helena Ribe, David Robalino, Andrew Mason (co TTLs), Javier Baez, Rodolfo Beazley, Fabio Bertranou, Cristoph Kurowski, Francesca Lamanna, Rafael Rofman, Maria Laura Sanchez Puerta, Ian Walker, and Eduardo Zylberstajn. *Background papers* and other valuable inputs came from Pablo Acosta, Ramon Castano-Yepes, Aline Coudouel, Wendy Cunningham, Vanessa da Silva Moreira, Mario di Filippo, Alvaro Forteza, Ariela Goldschimit, Jason Hobbs, Ricardo Charles Manzano, Edmundo Murrugarra, Christina Novinsky, Francisco Ochoa, Susan Parker, Jose Luis Salas, Manuel Salazar, John Scott, Maria Concepcion Steta, Sarah Thomson, Elio Valladares, Manuela Villar, and Alejandro Yepes. The team gratefully acknowledges the *support and advice* of Veronica Alaimo, Caridad Araujo, Laura Chioda, Tito Cordella, Augusto de la Torre, Pablo Fajnzylber, Margaret Grosh, Marcelo Guigale, Keith Hansen, Richard Hinz, Robert Holzmann, Dorothy Kronick, William Maloney, John Nash, Ana Revenga, Jamele Rigolini, Jaime Saavedra, Ilias Skamnelos, Andras Uthoff, Salvador Valdés, Milan Vodopivec, and Hélio Zylberstajn. Special thanks to Fiona Mackintosh, Lerick Kebeck and Julia Nannucci who contributed to the editing and production of this report.

Introduction

Latin America is known internationally as the home of some of the world's most innovative social protection programs and policies. In the last two decades, many of LAC's social protection (SP) systems have been transformed and spending on SP has increased in importance *vis-a-vis* other government policies and programs. Many countries have reformed their pensions systems in an effort to improve the links between savings and benefits and to reduce their fiscal exposure to future deficits. The region has also seen a widespread expansion of targeted social health insurance systems that provide free or subsidized care to the poorest families. Perhaps most noteworthy of all has been the development of well-targeted conditional cash transfer systems which have brought millions of poor families within the scope of social protection 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 the population. 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 SI systems for pensions, health insurance, and unemployment benefits continue to be based on the mandatory enrollment of formal sector workers, who are a minority of the labor force.

The region's SI programs are also fragmented. In many countries, there are parallel schemes that offer different benefits to different segments of the labor force, even though they make similar contributions. This restrains labor mobility, creates inequalities, and increases costs. In an effort to close the coverage gap, several countries have introduced *non-contributory* social insurance programs (such as social pensions), but this has created dual systems – worsening fragmentation - and in some cases might have provided incentives to informality.

In addition, in many countries, “solidarity” subsidies in contributory social insurance, which are meant to be progressive, in practice, are often regressive. This happens because they are not transparent: the outcome depends on the interaction of a complex set of rules about contributions, benefits, and eligibility conditions. The resulting implicit taxes and subsidies also distort incentives and can induce evasion and other behaviors such as early retirement or reduced work-search efforts. Implicit subsidies have also caused serious problems of overall fiscal sustainability, because in practice they are not always fully funded by higher charges on other plan members. This leads to deficits in pensions systems and unemployment and health insurance plans, which must be financed from general taxes on current and/or future generations. .

Similarly, although there have been positive developments linked to the expansion of the Conditional Cash Transfer (CCT) model, the region's social assistance (SA) and labor market programs have yet to achieve their potential in terms of poverty prevention and human capital promotion. To ensure that CCTs produce better human development outcomes, there is a need to improve the quality of the associated health and education services. There is also a need to define a safety net strategy for the urban poor, who face different problems from the structural poverty of the rural extreme poor, but can be very vulnerable to economic shocks.

Labor market programs also face challenges. Their design often fails to respond to the factors that constrain access to good quality jobs. Training programs – the main form of support offered - are often supply driven and benefit mostly formal sector workers. Job search intermediation services and interventions to increase the labor market opportunities of low-skilled

workers, particularly youth, are underdeveloped. Moreover, the 2008/9 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 bridge them through to their next job.

The current socioeconomic environment in LAC counties is conducive to reforms in social protection systems to address these challenges. There is a growing social consensus on the need for a more equitable income distribution and for improving social inclusion and a general recognition that better social protection policies can contribute to those goals.

Objectives and Organization of this Report

This report takes stock of recent reforms and charts a way forward to improve outcomes, in terms of program coverage and adequacy of benefits. It aims to inform policy discussions about the design of social insurance, social assistance, and labor market programs.

The report builds on an extensive literature about the reform of social protection systems in LAC.¹ A central theme is that a well-functioning SP system must be cognizant of the realities of the region's labor markets – especially the persistent prevalence of high levels of informal employment, where the government is unable to impose mandates such as compulsory social insurance. It should also take account of the likely effects of policies and programs on the behavior of beneficiaries and providers, through the incentives and disincentives provided 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, shows that some subsidized SP systems might be encouraging informality and undermining productivity growth. Baeza and Packard, 2006 argue for financing health insurance from general taxation, to overcome exclusion problems. Gill et al, 2004 analyze the failure to date of many of LAC's funded, defined contribution pension systems to increase coverage or improve efficiency. Grosh et al. (2009) highlight the importance of strengthening safety nets linked to human capital development for the region's extreme poor.

This report aims to move the debate forward by: (1) developing a common policy framework for the social protection 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. Reforms in social protection to date have paid too little attention to the impact that one program can have on the performance of others.

The report is organized in four parts. Part I describes the point of departure. It reviews in some detail the recent progress in SP coverage, presenting new cross-country data on the scope of contributory and non contributory programs. It then analyses the institutional arrangements, benefit adequacy, financial sustainability, and distributional and incentive effects of the various types of SP programs. The section flags the main challenges faced by SP systems, with an emphasis on those that run across programs.

Part II proposes a vision for the future development of region's SP systems. It outlines a conceptual framework which highlights the three SP objectives of consumption smoothing, poverty prevention and human capital promotion to reduce vulnerability. The framework shows how different types of SP programs (such as savings, insurance 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)

¹ See, for instance, de Ferranti et al. (2000); Gill et al., (2004); Baeza and Packard (2006); ECLAC (2006), Levy (2008), and Grosh et al (2009).

are available. Finally, it highlights the potential indirect effects of SP programs on the behavior of individuals and firms (through incentives to work, save, insure, and enroll in contributory programs); on the behavior of SP service providers; and on 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, identified in Part I. These include the suggestion that *contributory social insurance* should be opened up to informal sector workers on an optional basis, with proper financial and institutional incentives; that social insurance benefits should be aligned with the value of contributions; and that subsidies should be transparent, targeted on workers with limited savings capacity, and financed out of general taxation. Where possible, SI programs covering different populations or risks should be consolidated and their benefits packages harmonized. At the same time, *safety net programs* for poverty reduction should be targeted based on poverty criteria and program rules should be crafted to avoid creating disincentives to work or save. Greater emphasis should also be placed on interventions that *promote human capital* and thus reduce vulnerability by strengthening links from SP programs to improved health, nutrition and education outcomes. There is also a need to improve the design of active labor market programs 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 avoid conflicting policies.

Part III then explores in detail the implications of this framework for the design of LAC's social protection programs, dealing in turn, with pensions, health and unemployment insurance, active labor market policies, and targeted anti-poverty income transfers.

Finally Part IV discusses the political economy of reform, highlighting the implications of initial conditions (the reforms that are already in place) for the path that countries can take towards implementing more effective and inclusive SP systems.

I. The state of Social Protection in LAC: recent progress and pending challenges

This first part of the report details recent progress in SP coverage in LAC, presenting new cross-country data on household access to contributory and non-contributory social insurance, and highlights the future challenges facing the region's SP systems. The discussion covers (i) social insurance for pensions, health and unemployment risks (consumption smoothing); (ii) poverty prevention and social safety net programs; and (iii) labor market programs to improve access to good 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 twenty years. We then identify five principal challenges facing SP policymakers in LAC: increasing the coverage of contributory social insurance (SI); tackling the fragmentation of SI systems; reforming subsidies to SI to make them transparent and progressive and strengthening incentives for low-income workers to contribute to SI programs; enhancing the effect of anti poverty programs on the promotion of human capital; and improving the working of labor markets to reduce employment risks for low income workers.

Recent developments and pending challenges in LAC's SP systems

Starting with Chile, many LAC countries have redesigned their *social insurance* programs in an effort to make them more financially sustainable and to improve workers' incentives to save and work. This has led to major advances towards fairer, more sustainable pensions systems, where retirement benefits (beyond a minimum floor) are proportional to the amount each worker saves during their working life. In health, the development of stronger national health services and especially, of targeted social health insurance programs that cover the cost of basic services for the poorest families, has facilitated steady improvement in health outcomes. Some countries have also strengthened unemployment insurance and/or reformed severance pay by developing unemployment individual savings accounts. These provide income protection against job loss without undermining work incentives and can be combined with targeted redistributive arrangements to protect low income workers facing higher unemployment risks. These are considerable achievements, since the reform of pensions, health systems, and of any form of transfer or subsidy is always politically difficult.

Many countries have also rationalized and expanded their *social safety nets*, moving away from *ad hoc* assistance programs and price subsidies towards well-targeted cash transfers. Conditional Cash Transfer (CCT) programs have now been adopted by most countries in the region, benefitting millions of the poorest households, who were previously excluded from social protection. The CCT model, which originally arose in LAC, has been exported globally. It has led to a sea-change in the attitudes of policy makers in many developing countries towards the rationale for providing income support to the poorest households, by linking it to requirements to take up basic health, nutrition and education services. Previously, concerns about benefit dependency and long term sustainability had blocked the development of safety nets in many countries.

Progress has also been made in increasing the effectiveness of *labor market programs* by integrating interventions that simultaneously address problems related to the lack of skills (technical or soft) and job search constraints, especially among low income youth and unskilled workers. The *Jovenes* programs are a good example. They have been very successful in improving labor market

opportunities for youth in terms of employment and wages. Their success is rooted in making training content demand-responsive, using a competitive bidding process for the provision of training services, and offering consistent financial incentives for employers and employees.

Nevertheless, the region's SP systems face five major challenges. The *first* challenge is that of expanding the coverage of contributory social insurance. Data on social insurance coverage and on the region's labor market dynamics show why the traditional approach to social protection – based on mandatory social insurance for contributing formal sector workers – cannot work in the way its architects expected. The system never covered the rural poor, and growing informality has also left many urban dwellers excluded. Even those who do have some access to social insurance are often not covered continuously, due to breaks in employment.

The *second* challenge relates to improving the integration of social insurance programs and institutions, and the rationalization and harmonization of their mandates, that is, the level of benefits they offer. Those covered by social insurance often receive very different benefits, depending on where they work or their level of income, and not on what they contribute. In some cases, benefits are overly generous and unaffordable, leading to large unfunded liabilities; in others, they provide inadequate coverage.

The *third* challenge is to improve the design of subsidy systems, by making them more transparent, equitable and incentive-compatible. This is a pre-requisite for extending coverage to all. Implicit subsidies within the social insurance system are costly and inequitable, and can negatively affect workers' decisions about participation in social security, the choice of formal as opposed to informal work, job search and savings efforts and the timing of retirement. In addition, the fact that this redistribution is financed through pay-roll taxes increases the tax wedge (the difference between the cost of labor to the firm and the worker's net remuneration or take-home pay) and as a result, can reduce formal employment. Finally, implicit subsidies within contributory social insurance programs are often poorly articulated with subsidies to non-contributory social insurance and anti-poverty programs. This fragments the SP system and in some cases, reinforces incentives for informal work.

The *fourth* challenge is to enhance the effect of social assistance and safety net programs of SP systems on poverty reduction and the promotion of human capital. This implies optimizing the design of Conditional Cash Transfers (CCT) programs to better integrate them with the supply of education, nutrition and health services while shoring up their targeting systems, modernizing beneficiary registers and improving procedures for entry to and exit from the programs. The *fifth* challenge is to rethink the design of active labor market programs, to improve the employability of low skilled workers and facilitate their access to better quality jobs, thus reducing labor market risks.

A cross-cutting theme common to all these challenges – and which has been highlighted by the events of the last 18 months - is the urgent need to strengthen *crisis response capacity* in LAC's SP systems. This implies expanding the income protection provided by contributory social insurance (especially unemployment insurance); expanding the coverage of safety net programs that can be geared up to offset temporary price spikes or to provide temporary employment in the face of economic downturns; and enhancing the capacity of labor market institutions to link workers to better quality jobs and reduce labor market risks.

Challenge I: Contributory social insurance coverage remains low and limited to the formal sector

The most critical social protection challenge facing LAC countries is the need to expand the coverage of contributory social insurance (SI) to a much larger share of the workforce. There is no single, unified indicator of social insurance 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 and unemployment insurance. In general, low income workers, those working in small firms, and those living in rural areas are less likely to be covered. Formal sector employees often enjoy a multi-dimensional package of social benefits, while informal sector workers and the unemployed have limited access to the social protection system.

In the 1990s, in most countries, pension coverage rates were below 40 percent of the economically active population (EAP). Twelve of the 18 countries had coverage rates below 40 percent. Only Chile, Uruguay, and Costa Rica are providing pension protection to more than half of their EAP, while Argentina, Brazil, and Panama cover between 40 and 50 percent. Despite structural reforms that aimed to improve incentives to enroll, there has been little increase in coverage. Among 15 countries for which comparable data exist for the 1990s and 2000s, coverage rates declined in five countries; remained almost unchanged in four; and showed a modest improvement in only four countries (Figure 1).²

Moreover, pension coverage is skewed against people at the bottom of the income distribution. In the mid 2000s, coverage in the first quintile was below 10 percent in 10 of the 18 countries in the sample (ranging from 0.2 percent in Bolivia to 8.0 percent in Colombia). In contrast, at the other end of the income distribution, coverage was on average nearly 60 percent (Figure 2). Chile and Costa Rica are the exception: their coverage is more evenly spread across income groups. In most countries, inequality remained roughly constant between the 1990s and the mid 2000s.

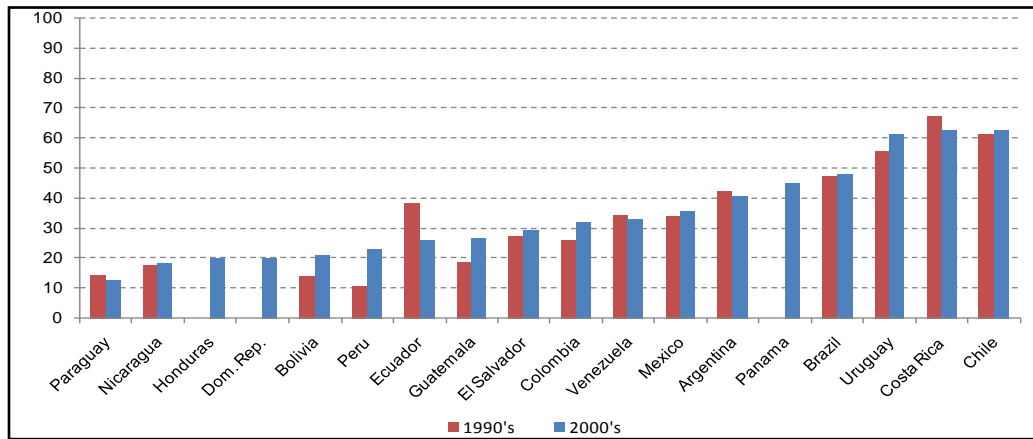
There are also differences in coverage by region and type of firm. Rural coverage is only one third of urban coverage. Coverage in the primary sector is lower than that of manufacturing and services. There is relatively low coverage in the private sector; among employees of small firms; among independent (self employed) workers; and among the unemployed.

Across the region, access to health services is a constitutional right. Countries can be grouped into two broad categories: those with a single, integrated public system³, and those with fragmented systems, where NHS and social health insurance programs operate in parallel. In either case, at least in principle, health insurance coverage is universal, as reflected in open access to the National Health Service (NHS) part of the system. However, benefits under the NHS tend to be below those of the contributory social health insurance programs. Meanwhile, coverage of the more generous contributory systems is low. Only four countries have coverage between 70 and 90 percent; all others have coverage rates below 50 percent and therefore rely primarily on NHS services (Figure 3). As with pensions, low income individuals are less likely to be part of the social health insurance system, although Costa Rica, Uruguay, Argentina and Chile report markedly better access for middle and low income workers than most other countries in LAC (Figure 4).

² Pension coverage can be measured either at the contribution stage or at the pay-out stage, but measured either way, pension coverage in LAC is low, with significant inequalities across the income distribution. The data cited in the text are based on the contribution rate of the EAP, but Rofman et al (2008) also show that coverage at the pay-out-stage resembles the trends and inequalities for the EAP.

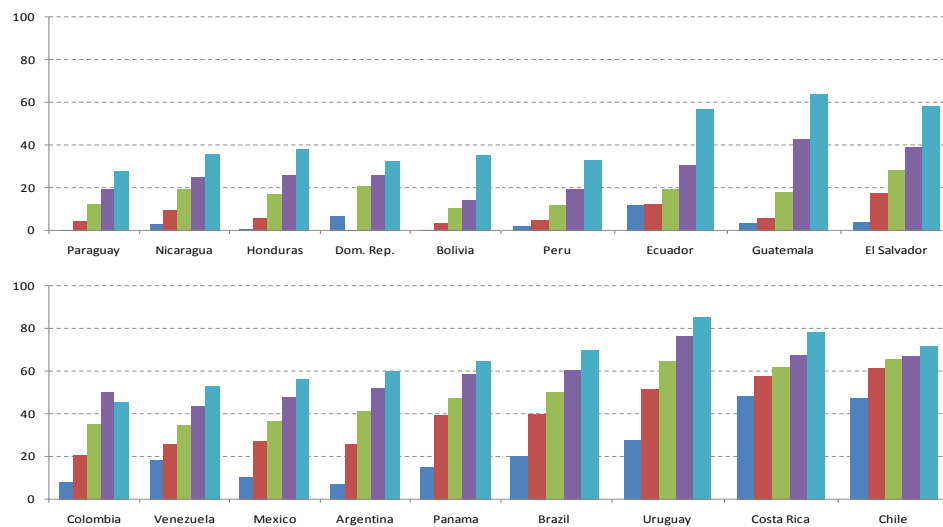
³ This is usually a national health service, but in some cases, such as Costa Rica, it is a social health insurance system.

Figure 1: Contributory Pension Coverage in Latin America and the Caribbean, 1990s to 2000s
(Percentage of economically active population contributing to pension systems)



Source: Rofman et al (2008). Note: Data are for the year that comes closest to 1995 and 2006, respectively.

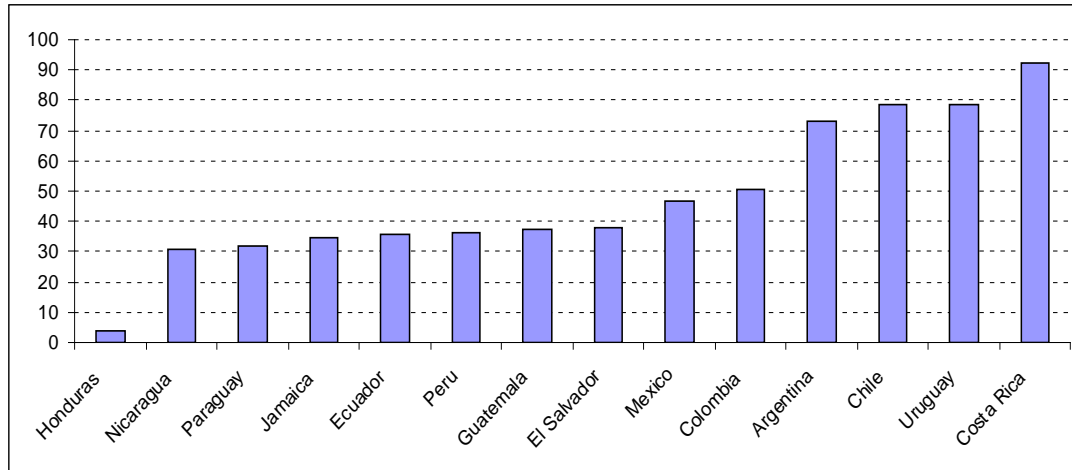
Figure 2: Contributory Pension Coverage Rates in Latin America and the Caribbean in the 2000s, by Quintile of Per Capita Income
(Percentage of economically active population contributing to pension systems)



Source: Adapted from Rofman et al (2008)

There are no household data on the coverage of unemployment benefits, but the available evidence suggests that a very low percentage of the unemployed receive some form of benefit. The majority of countries still rely on severance pay as the main income protection system. Severance pay, however, is unreliable, since employers do not provision funds to finance their liabilities with the program and it is difficult to enforce payment. For instance, in Argentina, less than 3 percent of the unemployed receives severance pay. On the other hand, in the countries that have developed unemployment insurance or unemployment insurance savings accounts, coverage rates are extremely low. Only Brazil has as many unemployment accounts as it has employed workers – other countries have less than a quarter of their workers covered (Figure 5).

Figure 3: Contributory Health Insurance Coverage in LAC, mid-2000s
(Percentage of population covered)



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

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

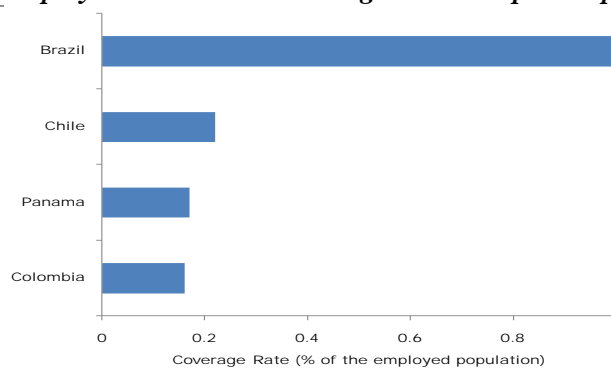
Figure 4: Contributory Health Insurance Coverage in LAC, mid-2000s, by Decile of Per Capita Income
(% of population covered)

■ D1 ■ D2 ■ D3 ■ D4 ■ D5 ■ D6 ■ D7 ■ D8 ■ D9 ■ D10

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 5: Unemployment Insurance Savings Accounts per Employed Worker

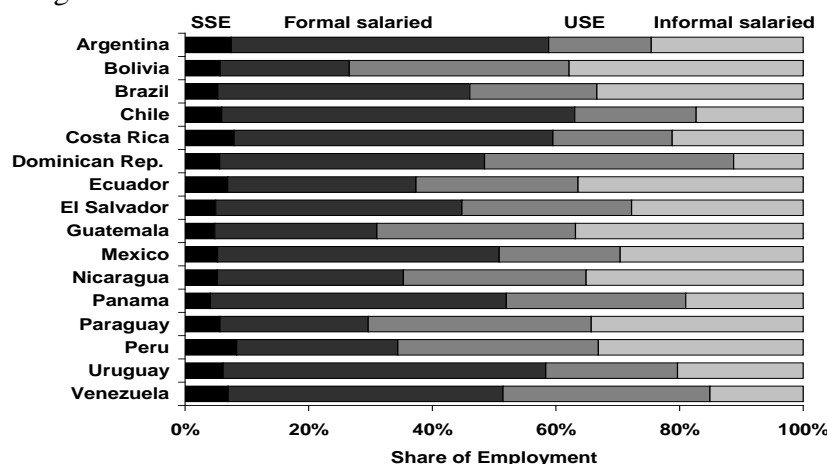


Source: Ferrer and Riddell (2008). Note: 1= 100%.

The continuing low coverage of LAC's SI systems should not come as a surprise. Their design was based on the Bismarck model, where SI entitlements are linked to mandatory contributions from workers and their employers. It was assumed that, as the region's economies developed, the majority of the labor force would come to be working in formal, salaried jobs, where SI contributions could be enforced. But a sizable share of the labor force continues to work in the agricultural sector, where it is difficult to enforce social security. It was also overly optimistic to expect that productivity in small and medium-sized enterprises, which are important sources of jobs, would always be high enough to cover the cost of social security contributions. To make matters worse, the region's SI systems failed to incorporate incentives to comply with regulations (including the payment of taxes). Poor governance, regulatory uncertainty, and corruption have reduced the expected benefits from formality and have induced evasion of social security.

Today, over half of LAC's workforce is employed in the informal sector and so is not covered by social security. Far from declining, in many countries informality has risen in recent decades. The lowest level of informality is in Chile (around 40 percent), and the highest is in Bolivia (close to 75 percent) (Figure 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). 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.⁴

Figure 6: Share of the formal and informal sector in LAC labor markets



Source: World Bank calculations based on statistics from SECLAC.

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

⁴ Turnover is measured by the *transition rate*, defined as the percentage of individuals in a given gender/age/income category who leave the social security system in a given month (for reasons other than retirement).

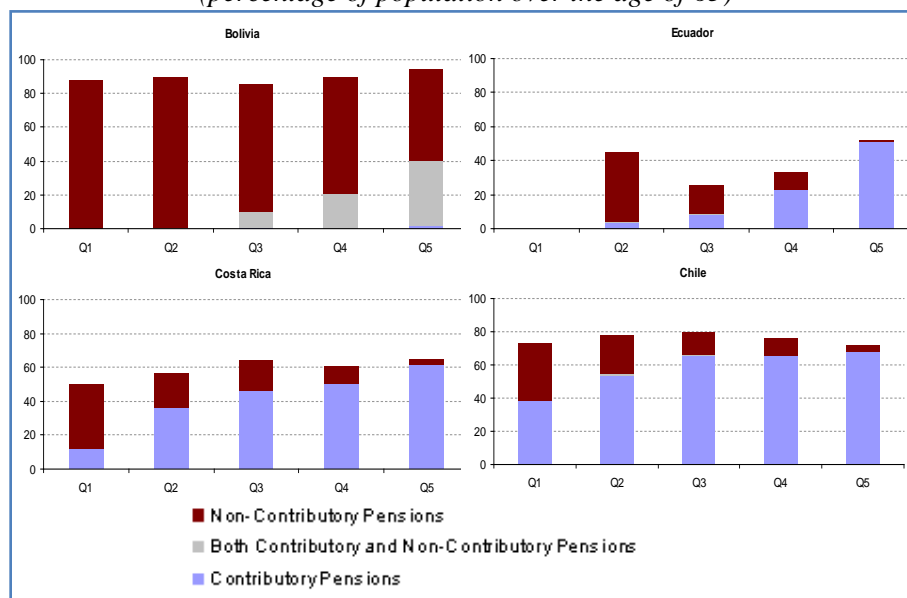
Table 1: Contribution Densities in Argentina, Chile and Uruguay

	Argentina		Chile		Uruguay	
	Mean	Median	Mean	Median	Mean	Median
Total	55	56.7	47.2	47.4	58.4	61
Sex						
Men	56.9	61.2	53	55.4	59.6	63
Women	55	55.6	39.7	35.7	57	58.1
Income bracket						
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
Age						
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 et al (2009).

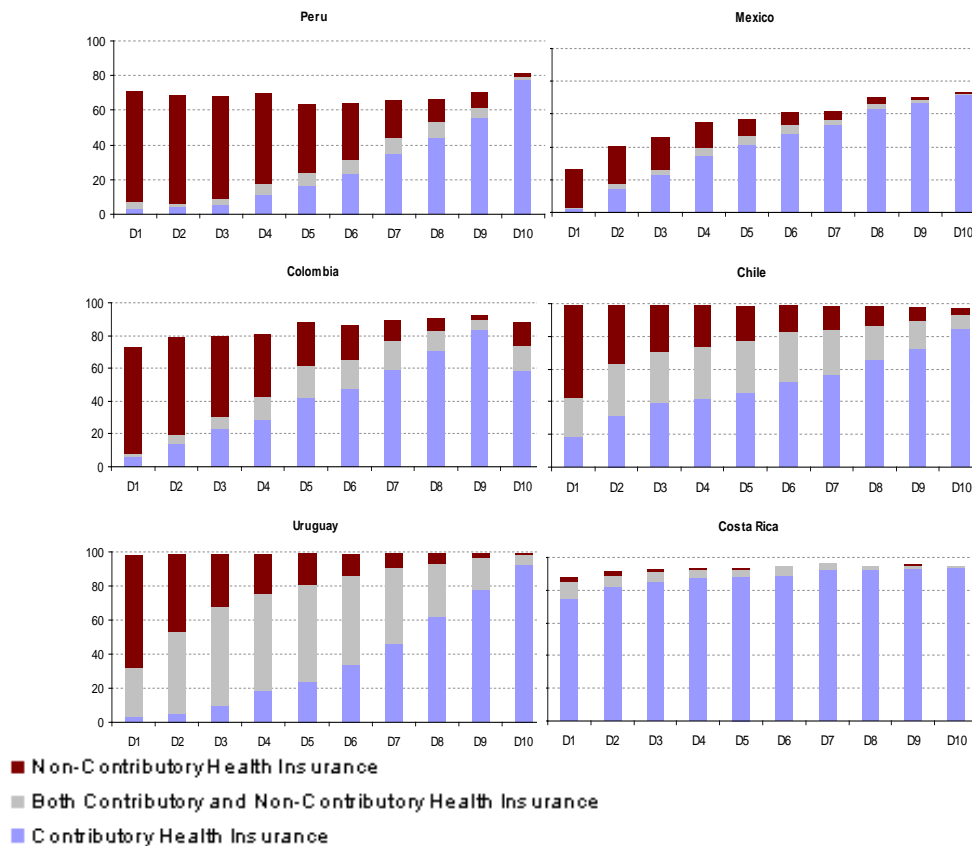
In response to the problem of the low coverage of contributory SI, many governments in LAC have introduced non-contributory pensions and health insurance systems. These have been important in closing the coverage gap and providing access for low-income individuals and the poor (see Figure 7 and Figure 8). But these programs are generally not well-integrated with contributory programs and have a number of problems in terms of financial sustainability and incentives, which are discussed below.

Figure 7: Contributory and Non-contributory Pension Coverage among the Elderly, 2000s, by Income Quintiles and Source
(percentage of population over the age of 65)



Source: World Bank staff calculations adapted from Rofman et al (2008).

Figure 8: Contributory, Non-contributory, and Combined Health Insurance Coverage, 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 non-contributory health insurance. All data are from 2006.

Challenge II: LAC's social insurance systems are fragmented and inequitable

In addition to having continuing low overall coverage rates, LAC's contributory social insurance 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, the link between a system's parameters, rules, and benefit entitlements is not clear and transparent. In addition, in many countries there are multiple income protection (unemployment insurance), pensions and health insurance systems operating in parallel, often with no coordination. In income protection, for example, there are eight countries with integrated systems and eight without. In pensions, there are nine countries with full integration and four with partial integration, but there are still four countries with multiple, un-integrated systems (Brazil, Mexico, Paraguay and Peru). Disintegration is most severe in health, where only Brazil and Costa Rica have fully integrated systems while all other countries have two or more un-integrated systems (Table 2).

Across countries there is a large variation in the benefits offered by social insurance programs. For instance, in pensions, replacement rates for the average worker range from 120 percent in Uruguay to as low as 33 percent in Mexico (see Figure 9). Similarly, the number of monthly salaries replaced by unemployment benefits runs from two weeks in Paraguay to over nine months in Argentina. It is normal to expect that differences between countries' social preferences and economic

and political conditions should lead to differences in social insurance mandates. However, the observed variations do not necessarily reflect deliberate choices about the objectives of the programs nor do they necessarily reflect the amount paid for insurance. Rather, the pattern of benefits and contributions tends to be the cumulative result of decisions made through 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 Figure 9, in some cases there are large variations between social insurance schemes within the same country. For instance, schemes for civil servants and the military are normally more generous than schemes for private sector workers. Statistics reporting the proportion of the working population that is covered by social insurance as though all types of program were commensurate are therefore misleading.

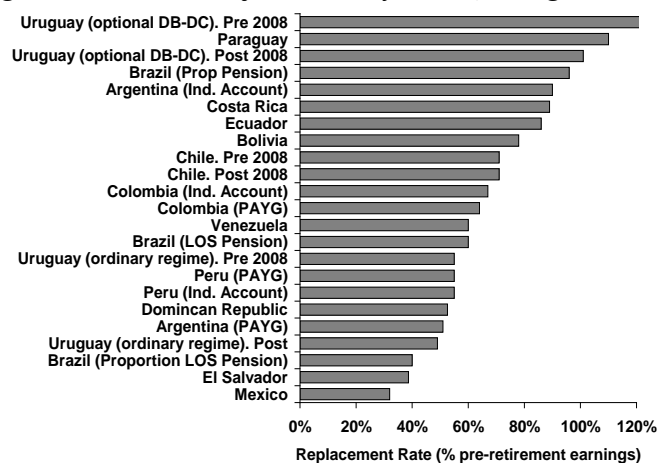
Table 2: Institutional integration of LAC's SI systems

	Income		
	Protection	Pensions	Health
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	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 there is only one system in the sector; *No* means there is more than one system; and *Partly* means there is more than one system but they are partially integrated.

Figure 9: Mandates of Pension Systems (average worker)



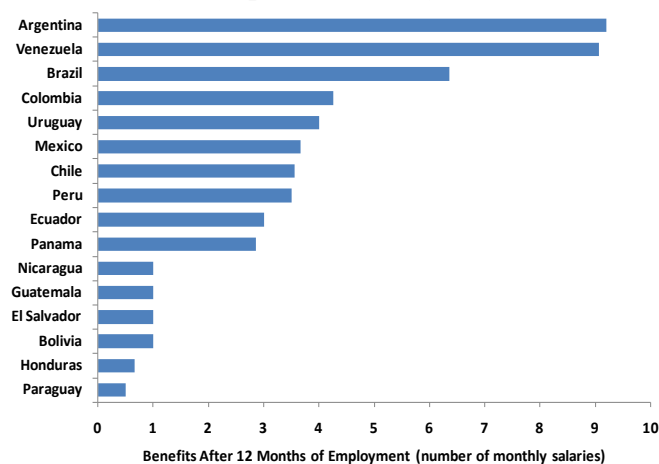
Source: World Bank staff calculations based on national SS legislations. Calculations are adjusted to make mandates comparable across countries.

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. The first reason is that 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 reduces the size of insurance risk pools and thus raises program costs, which is a major issue in many health systems. Third, administrative costs can also increase, because multiple systems reduce economies of scale (a large share of administrative costs are fixed). Finally, in the case of health, mutual exclusivity across health programs and a lack of consumer choice among care providers leads to significant inefficiencies in the production of health care (for example, low utilization of capacity in health facilities) and in health care outcomes (for example, sub-optimal allocation of care). The Mexican health system is a classic example. As discussed below, by breaking up the risk pool fragmented health systems also increase costs.

Another, related, problem is the lack of coordination in the design of different types of social insurance programs and among social insurance, social assistance, and labor market programs and policies. For instance, old-age income support, health, and anti-poverty reforms have been implemented in a piecemeal way, with policymakers giving little attention to the interactions between them. There are few countries where active labor market programs are linked to income protection programs. Similarly, policies on disability pensions are seldom coordinated with policies on unemployment benefits. This is seen in Chile and Argentina, where disability benefits sometimes substitute for unemployment benefits. This affects the overall coherence of the SP system. Better coordination could 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.

Figure 10: Mandates of Unemployment Benefit Systems (average worker)



Source: World Bank staff calculations based on national datasets.

In summary, to meet the challenge of extending coverage, increasing the adequacy and improving the equity of social insurance, policymakers will need to review program mandates and should consider moving towards more integrated (or at least more harmonized) schemes and better coordinated policies.

Challenge III: Social insurance subsidy systems are opaque and regressive, and distort incentives to work and save

As discussed above, social insurance coverage for low-income people in LAC is very limited. For the extreme poor, enrolling in contributory social insurance programs is simply not an option. But even the moderate poor – who do have some savings capacity – are usually excluded. Many work in small

firms, where productivity is too low to cover the full cost of mandatory social insurance. In addition, they often have relatively high personal discount rates and preferences for liquidity and a correspondingly low demand for long-term savings and insurance.

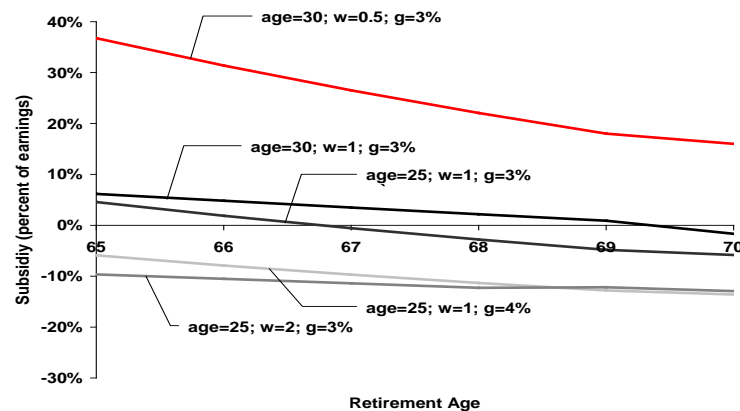
LAC's policymakers have introduced two types of intervention to extend the reach of SP systems to low-income workers. The first is pure anti-poverty programs, which we will discuss in the following section. The second type, discussed in this section, is subsidies to social insurance.

There are two variants of social insurance subsidy: (i) implicit subsidies to some plan members within the contributory systems, which are generally financed through payroll taxes and social security contributions levied on other plan members ; and (ii) explicit subsidies for non-contributory pensions, unemployment, or health insurance programs, which are usually financed out of general tax revenues. In terms of redistribution the first type of subsidy is often regressive while the second is in most cases progressive. But if they are not carefully designed, both , can have negative incentive effects on labor supply and savings and reduce participation in contributory social insurance.

Implicit and non-transparent subsidies and taxes

LAC's contributory SI systems are plagued by implicit and non-transparent subsidies and taxes that result from badly designed benefit formulas and eligibility conditions and from *ad hoc* minimum benefit guarantees. 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).⁵ Figure 11 illustrates this for 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 can be considerable.

Figure 11: Implicit Taxes and Subsidies in the Brazilian Pension System

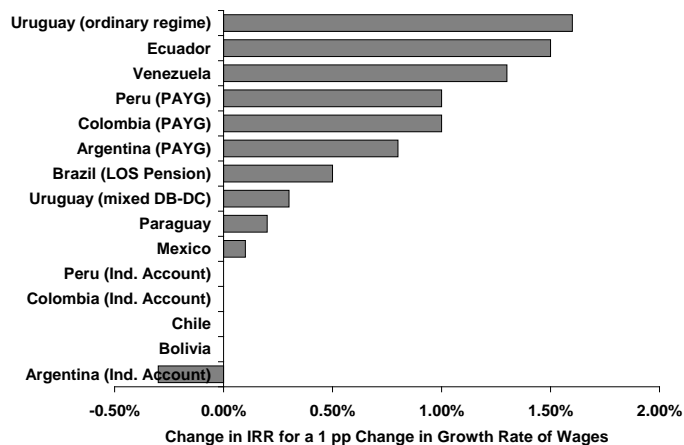


Note: Each line gives the value of the expected subsidy (or tax) as a function of the retirement age. The subsidy or tax is expressed as a percentage of the worker's salary. Each line is associated with a given age of enrollment, a given entry wage w (expressed as a proportion of average earnings), and a growth rate for this wage. We see that there is considerable variation on the level of the subsidy (tax) received (paid) as a function of when individuals enroll and when they retire and their level of earnings. Source: Author's calculations.

⁵ Systematic redistribution is different from the non-systematic redistribution of income that exists within any given risk-pooling arrangement. In a risk pool where 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 emerges 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.

In the Brazil example, the formal rules suggest that low income workers will receive implicit subsidies, as do those who join later or whose wages grow more slowly. But when all such effects are combined, the most common pattern across the region is that implicit taxes or subsidies are regressive. This happens in part because higher-income workers are more likely to remain in the system long enough to qualify for benefits. In contrast, low-paid workers face more instability and are less likely to compete the vesting periods required for benefit entitlement (see Forteza et al., 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 12).

Figure 12: Changes in Rates of Return on Contributions for Pension Resulting from a One Percentage Point Increase in the Growth Rate of Wages during Working Life



Source: World Bank staff calculations based on country datasets

Regressive redistribution can take place between plan members (e.g., when low income workers receive lower rates of return on their contributions or are less likely to receive unemployment benefits), or between plan members and other individuals who are not at present covered by the SI insurance system – including future generations. Indeed, in many of LAC's SI systems, the imbalance between contributions and benefits generates large, system-wide cash flow deficits, which must be covered by fiscal transfers. A recent study of eight LAC SI systems found an average annual subsidy of PPP US\$62 per person (Lindert et al., 2006). The estimated subsidies (as a percentage of total benefits transferred) were as follows: Argentina (57 percent), Brazil (40 percent), Chile (56 percent), Colombia (77 percent), Dominican Republic (0 percent), Guatemala (25 percent), Mexico (84 percent) and Peru (89 percent)⁶ (Table 3). Since (as was seen above) the beneficiaries of most SI systems are towards the top end of the income distribution, fiscal subsidies to cover such deficits are likely to be 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 subsidies to social insurance benefit the top quintile of the income distribution, while only 3 percent benefit the bottom quintile. In contrast, non-contributory social assistance channels 26 percent of benefits to the bottom quintile and only 14 percent to 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

⁶ In some cases, these 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.

bigger relative impact on the incomes of poor households, increasing incomes of Q1 beneficiaries by 13 percent on average, compared with 2 percent for social insurance (Lindert et al 2006).

These numbers only take into account the cost of current deficits in the social insurance system. The situation can be even worse if the actuarial deficits of pay-as-you-go and unemployment insurance systems are taken into account. For instance, many of LAC's young pay-as-you-go pension systems gave their contributors a "free dinner," levying small contributions relative to benefits because there were few retirees' pensions to finance. However, dependency ratios have now increased. If the remaining pay-as-you-go systems' contributors continue to pay contributions which are less than the value of their future rights, then either a future generation will have to pay more than the value of their own pension to offset this, or the tax system will have to pick up the bill. Neither of these outcomes is ideal.

One way to measure the size of this problem is to estimate the liabilities of the system (i.e., 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 GDP (Holzmann et al., 2004).

Table 3: Distribution of Subsidies to Social Insurance and Social Assistance in LAC

Country	Social Insurance/1					Social Assistance				
	Average unit benefit	Benefit incidence/2		Impact on income/3		Average unit benefit	Benefit incidence/2		Impact on income/3	
	\$PPP	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
Average/4	62.0	2.9	58.0	2.1	3.2	15.8	25.9	13.9	12.9	0.4

Source: Derived from Lindert et al (2006), Table 4a, page 64.

Notes: 1/ The subsidy share of social insurance is defined as the proportion of total cash flow expenditure of SI which is funded from taxation rather from members' contributions or interest income to the insurance funds. This study did not attempt to calculate actuarial deficits. 2/ The proportion of the total benefit which is received by households in the bottom quintile (Q1) and top quintile (Q5). 3/ The relative impact of the benefit received on household income in Q1 and Q5 respectively. 4/ Un-weighted average for the eight countries.

Implicit taxes and subsidies also affect individuals' behavior, because they create incentives to strategically manipulate wages, retire early, reduce job search efforts, and, in general, reduce labor supply and savings. For example, under existing rules, the ratio of pension entitlements to contributions can be affected by the timing of enrollment and retirement, by career histories, and the frequency (density) of 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 13). Similarly, pension benefit rules based on final salaries reward income growth in

the last years of work with higher rates of return, creating incentives to negotiate large salary rises close to retirement.. In like manner, the amount of subsidy received from unemployment insurance often depends on the frequency and duration of episodes of unemployment. In health insurance, the amount of subsidy received depends on patterns of use of health services. When health insurance contributions are based on income, while expected benefits are based on family demographics, this may stimulate collusion between workers and employers to under-report earnings, in order to minimize contributions without affecting benefits.

An additional problem with the implicit redistribution in contributory systems is that it is financed through payroll taxes – in addition to the implicit taxes paid by some plan members. Both increase the tax wedge⁷. There is considerable international evidence that this can reduce employment levels and promote informality. In Eastern Europe and Central Asia, 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/population ratio.⁸

Figure 13: Impact on Rate of Return on Contributions of Increasing the Retirement Age from 65 and 70



Source: World Bank staff calculations based on country datasets.

A recent study of Turkey found that the “pass through” of social security contributions to wages is low for low-income workers, so increases in contributions lead to increased total wage costs and reduced employment.⁹ It is estimated that a rise in payroll taxes of over 10 percentage points (from 41 to 51.5 percent) in Colombia between 1989 and 1996 led to a decline in formal employment of 4 to 5 percent.¹⁰ The point is not that social insurance benefits should not be financed by contributions from employees and, when available, their employers. This is justified by the fact that, in the absence of a legal mandate, many workers might systematically 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 that finance redistribution (i.e. pay for other peoples’ benefits), they increase

⁷ The tax-wedge is defined as the difference between the total cost of labor paid by the employer (which includes pay-roll taxes) and take-home pay (which equal to the gross wage minus workers social security contributions and income taxes). In principle, social security contributions that are directly linked to social security benefits are not considered a tax. Similarly, pay-roll taxes which are directly linked to benefits could be considered part of the compensation package and therefore have a lower negative effect on employment.

⁸ Rutkowski (2007).

⁹ Betcherman and Pages (2008).

¹⁰ Kugler and Kugler (2003).

the tax-wedge for the workers who pay them and are therefore likely to have a negative effect on formal employment. Alternative options for the funding of the solidarity element of the SP system are discussed in Section 3.¹¹

Explicitly subsidized non-contributory programs

As discussed in the previous section many countries have established non-contributory SI programs, funded from general taxation, for workers in the rural or urban informal sectors.

These programs have contributed to closing the coverage gap but bring problems of their own, particularly if the benefits they offer are reduced or eliminated when a worker gets benefits from a contributory program. Indeed, the non-contributory programs are often 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 non-contributory programs). However, as discussed above, this is often not the case. During their working lives, many individuals move in and out of the social security system, sometimes as a result of their own preferences (see Perry et al, 2007).

In this setting, those non-contributory programs for which access is conditional on informality (or on non-eligibility for contributory SI benefits) act as an implicit tax on formal sector work: *ceteris paribus*, workers taking formal sector jobs lose part of the benefit of the non-contributory transfers.

In general, if non-contributory benefits are reduced when a person receives contributory benefits, this contributes to the effective marginal tax (EMTR) on formal sector earnings. The minimum pension guarantee in Brazil and the minimum pension in Chile 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 transfer pension is reduced by one unit. As a result, low-income workers find that contributing more does not increase their total pension.¹² In general, 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 also 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. However, if 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. This idea is illustrated in Figure 14.

The more generous a program, the more likely it is to affect behaviors. This can be seen when

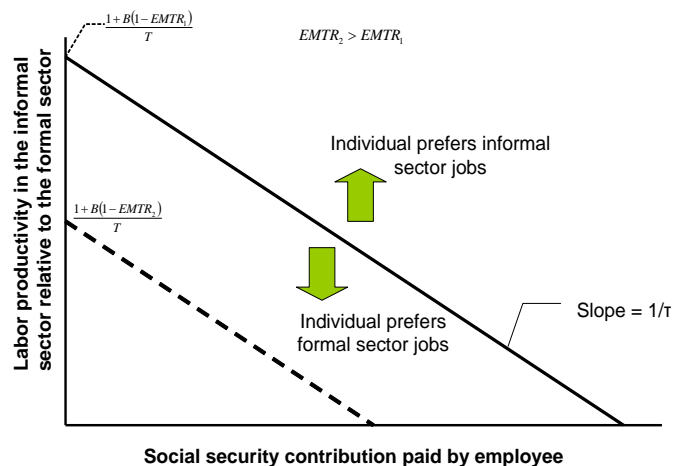
¹¹ Income taxes also contribute to the tax wedge, but they are normally at least as progressive as SI contributions and there is little evidence that they are less acceptable to workers than SI contributions, so a shift from SI contributions to income tax as a source of funding would not be likely to lead to negative reactions. Income taxes are also likely to be more efficient than pay-roll taxes levied on employers. The general issue of the socio-political choices to be made in structuring the tax system between different types of revenue raising instrument – sales tax, income tax, property tax etc - goes beyond the scope of this study. For an excellent review the reader is referred to Auerbach and Shaviro, (2008).

¹² In the case of non-contributory programs such as the Bolivian social pension, *Renta Dignidad* moving into the formal sector does not lead to a loss of benefits – there is not tax. The cost of a universal pension, however, is much higher (see Holzmann et al., 2009). In many NHS health services, moving into the formal sector also does not lead to a loss of benefits from the subsidized program. However, the availability of a free health service of similar quality to the one provided through the contributory insurance system renders the value of the contributory benefit null and thus converts the corresponding contribution into a tax.

comparing the impact of non-contributory health insurance systems in Mexico and Colombia. Mexico's subsidized health regime, *Seguro Popular*, offers net benefits¹³ that are higher than those of the formal health insurance regime operated by the Mexican social security institute, IMSS. Therefore, the availability of the program increases the likelihood that individuals will take informal sector jobs (Parker and Scott, 2008). In contrast, Colombia's *Regimen Subsidiado* is targeted to low-income informal workers, who would have little access to formal jobs under any circumstance. There is little evidence of a resulting increase in informality. Nevertheless, there is some evidence that some small business owners now make employment contingent on affiliating to the *Regimen Subsidiado* (Gaviria, 2006; Camacho and Conover, 2007; and CIDER, 2007).

The issues discussed here would be less important if informality did not impose significant economic costs. There is evidence, however, that informal production units tend to have low productivity, because they are unable to benefit from economies of scale and because they have difficulty accessing markets and credit. Therefore, any policy which creates incentives to informality may also undermine growth. Levy (2008) has argued that the recent development of Mexico's social protection system has unintentionally promoted the growth of small-scale, informal firms, which are intrinsically uncompetitive and have limited growth potential. The underlying concern is that if this were a systematic occurrence, the introduction of non-contributory elements in LAC's social protection system might threaten long-term growth potential by reinforcing the flow of workers into informality.

Figure 14: The Impact on Choice of Informality an Increase in the Effective Marginal Tax Rate (EMTR) on Formal Wages



Note: 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.

In conclusion, 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 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 human capital impact of poverty prevention

¹³ The net benefit of an insurance program is defined as the expected value of the benefit minus the cost of the contribution. In non-contributory programs, by definition, net benefits equal gross benefits.

programs

Throughout LAC, targeted income support for poor families is provided in the form of cash or in-kind transfers to alleviate poverty, to finance investments in human and physical capital, and to increase future incomes. These programs are sometimes referred to as “social assistance”, to differentiate them from social insurance schemes. They provide social protection to the uninsured population, within which most poverty and extreme poverty is concentrated. Eligibility is normally based on poverty levels using geographical targeting, household means testing or self-selection. (see Box 1).

Social assistance and poor relief have long formed part of public policy in LAC, but over the last two decades, large-scale poverty-targeted programs have become an increasingly significant part of the social protection architecture, in terms both of population coverage and expenditure (see Figure 15). This trend reflects a realization by policymakers – especially in middle-income countries – that the state has a legitimate role to play in guaranteeing minimum living standards and promoting the health and education of the workforce, social inclusion, and economic development.

There is also growing awareness that there are positive feedbacks between improved income distribution and growth outcomes (Perry et al., 2006). And the potential that targeted income support programs have to improve income redistribution and reduce poverty is considerable. Table 4 shows Gini trends for major countries in the region from the start of the 1990s to the mid-2000s. Of the 19 countries for which we have data, the Gini worsened markedly for 11, improved for five, and is unchanged in three. It is noteworthy that several countries that have given priority to developing income support programs (such as Brazil, Honduras, Mexico, and Nicaragua) exhibit the greatest improvements in income distribution.

The right-hand side of Table 4 shows why targeted income support can make such a difference. Due to the enormously skewed income distribution of most countries in LAC, the poorest quintile (20 percent) of the population generally accounts for less than 4 percent of household income. The figure is less than 3 percent in seven countries and in Bolivia it falls as low as 1.5 percent. In a situation where the pre-transfer income of Q1 households is only 3 percent of GDP, by assigning 1 percent of GDP to well-targeted transfers for households in the bottom quintile, governments could, in principle, increase the average disposable incomes of these households by one-third.

Finally, in the context of growing global economic instability, governments also need to respond to the impact of shocks on population groups that are excluded from formal social insurance systems. These groups are especially vulnerable to shocks, such as the “triple F” (food, fuel, and financial) crisis of 2008/9 and the 2009 global economic slowdown. When shocks occur, countries with established safety net and social assistance programs are better positioned to provide income support to the most vulnerable households and to connect them with other social assistance or employment support programs. The remainder of this section discusses some of the achievements and pending challenges in the design of social assistance programs focusing on two of the most important programs: conditional cash transfers and workfare programs.

The impact of CCTs on poverty and human development outcomes

Over the last decade, large CCT programs have assumed a dominant role in the social protection systems of many LAC countries. In several cases, there has been a shift of funding from untargeted consumption subsidies (for food or fuel, for example) – which are a fiscally and economically inefficient alternative to a targeted social safety net – towards targeted income transfers. For example, in Mexico, when *Progresa* (now *Oportunidades*) was established in 1997, it replaced consumption subsidies for maize.

BOX 1- A Typology of Income Support Programs in LAC

A complex array of income support programs operates in LAC today. These programs all share the goal of providing cash or in-kind support to the poorest households. Beyond that, their stated development goals are many and diverse, including alleviating long-term poverty, reducing exclusion, responding to short-term shocks and risks, improving the population's nutrition status, and improving equality and equity. Their benefits vary in size and type and include both cash and in-kind transfers. They take different approaches to targeting and beneficiary selection, including geographic targeting, demographic targeting (for example, targeting school pupils or old people), self selection (for example, participation in workfare programs), and sophisticated proxy-means test systems, which use statistical techniques to predict which households are in a given quintile or decile of the national income distribution, based on easily observed variables. The available household-level data are incomplete but they suggest that the covered population is above 30 percent in Brazil, Paraguay, Ecuador, Honduras, Peru, Chile, and Nicaragua (Figure 14). In many countries, the household-level coverage of income support programs now surpasses that of traditional social insurance.

Cash-based programs have grown in importance over the last decade. *Conditional cash transfers* (CCTs) are now the prevalent model for income support in LAC. CCT programs have been established in 15 LAC countries and benefit an estimated 22 million households (over 90 million people or 16 percent of the region's population). They exist (in several different designs) in Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Jamaica, Mexico, Panama, and Peru, and most of them are large-scale. The most distinctive characteristic of CCTs is "conditionality" (sometimes called "co-responsibility"). This refers to a requirement that program beneficiaries or their children must enroll in basic health, nutrition, and education services. However, the extent to which these conditions are enforced by the suspension of benefits varies widely. In Mexico's *Oportunidades* program, conditionality is taken very seriously; at the other extreme, Ecuador's *Bono de Desarrollo Humano* (BDH) program makes no effort to enforce it. Other distinctive features of most CCTs include the use of modern, goal-based management techniques, the selection of beneficiaries using rigorous poverty targeting procedures (at the geographical and/or household level), benefit levels that are high enough to significantly increase a household's consumption capacity, and the application of rigorous evaluations of process and impact.

An alternative way to transfer cash to the poor is through *workfare programs*, which offer paid temporary employment and, sometimes, training and work experience to the unemployed. Workfare programs are often expanded in response to cyclical upsurges of unemployment. Beneficiaries are "self-selected" in the sense that they choose to work on the program at the offered wage rate. Such programs have existed recently on a large scale in Argentina (*Trabajar* and *Jefes*) and Peru (*A Trabajar Urbano*, now renamed *Construyendo Peru*) and in Bolivia (PLANE).

Many LAC countries operate *social investment funds* (SIFs), which are similar to workfare in that they create temporary jobs in the construction of small-scale social and economic infrastructure and thus generate additional income. Such funds exist today in Bolivia, Peru, Honduras, Nicaragua, Guatemala, El Salvador, several Caribbean countries, and Jamaica. SIFs were the first type of social protection program in LAC to combine poverty targeting (through geographical poverty maps), large-scale interventions, and modern management techniques. The first generation of SIFs in the early nineties listed temporary employment creation as an explicit goal, but nowadays most SIFs emphasize the goals of fiscal decentralization, community-driven development, and/or improving small-scale infrastructure.

Food-based programs remain an important part of the income support system in many countries in LAC. They represent a more traditional, paternalist approach to social assistance and are somewhat prone to being "captured" by beneficiary groups. However, many countries have modernized food programs by applying similar management principles to those that characterize a standard CCT, including the clarification of goals, the consolidation of multiple programs, effective poverty targeting, and the inclusion of rigorous process and impact evaluations. The World Food Program has played an important role in improving the quality of food programs in LAC and in developing the use of food programs for crisis response in low-capacity countries such as Haiti.

As with cash-based income support programs, there are several different kinds of food programs. Many distribute nutritional supplements to mothers and babies in poor communities. There are also food-for-work programs, which (like workfare) use self-selection based on willingness to work as a targeting mechanism. School feeding programs with no explicit poverty targeting exist on a large scale in Haiti, Honduras, Peru, Ecuador, Bolivia, Colombia, Brazil, and Jamaica, and often achieve impressively low unit costs. Some countries are now promoting nutritional programs centered on achieving behavioral change, such as increased participation in nutritional monitoring and counseling. Examples are the PANN 2000 program in Ecuador or the AIN-C model in Central America. Using food distribution as an incentive to participate in such programs is analogous to the behavior-change goal of CCTs.

CCT programs now exist in 15 countries in LAC, with budgets ranging from 0.1 percent of GDP (Chile and Peru) to 0.6 percent of GDP in Ecuador (Figure 16). On average, they account for 0.25 percent of GDP, cover 16.9 percent of the population, and spend the equivalent of 3.1 percent of their countries' per capita income per beneficiary household.

Many CCTs provide relatively generous benefits, and their impact on the spending capacity of beneficiaries is significant, especially for the poorest. Figure 17 illustrates the impact of four of LAC's most important CCT programs on the intensity of poverty. *Oportunidades* in Mexico has reduced the poverty gap by 19 percent. In Brazil, *Bolsa Familia* has reduced the poverty gap by 10

percent.¹⁴ In Ecuador, the reduction is 14 percent. The smallest impact on these indicators was made in Jamaica (9 percent).

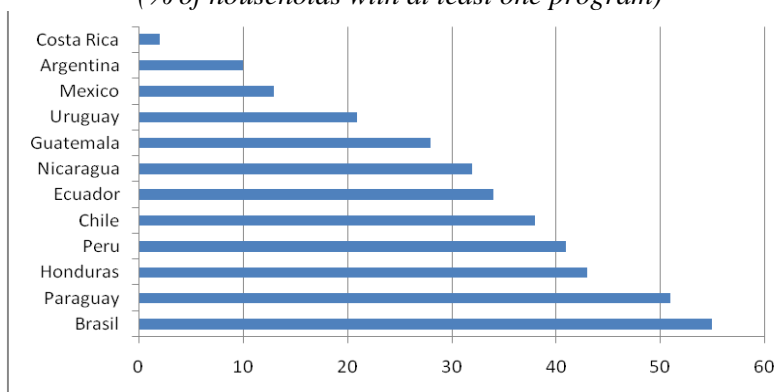
Beyond their immediate impact on households' spending capacity, income support programs have the potential to increase beneficiaries' long-term earnings capacity by increasing their human capital accumulation (due to education and health conditionality) and by helping households to increase their risk-taking and investments.

The available evaluation evidence suggests that CCT programs in LAC have somewhat increased school enrollment and attendance rates and have reduced school drop-out rates (Behrman at all, 2000, Britto 2004 and 2007, and Rawlings, 2005) and have increased take-up of vaccinations and in children's visits to health centers for growth and development consultations (Bouillon and Tejerina, 2006, Britto, 2007, and Rawlings, 2005), but have so far produced only modest improvements in higher-level health and nutrition outcomes. This indicates that increasing demand, alone, is not sufficient to improve outcomes and that policymakers should also take initiatives to improve the quality of the services. This is emerging as one of the main challenges for social policy in LAC.

Cash benefits that are conditional on the use of health, nutritional, and educational services – such as those offered by a CCT – can also make a big difference to how households re-allocate 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 children from school than households not enrolled in the program.

Cash transfers can also “crowd in” investment in higher-risk, higher-return activities. Households with secure cash incomes (such as a CCT benefit) are more likely to be able to borrow money and may also be more willing to take risks on activities with potentially higher returns than those generated by their traditional, conservative allocation of labor, land, and other assets. A recent study of the *Oportunidades* program in Mexico found that beneficiaries invested, on average, 12 percent of their transfer in productive activities such as micro-enterprises and agriculture (Gertler et al., 2006).

Figure 15 - Coverage of Income Transfer Programs in LAC
(% of households with at least one program)



Source: World Bank staff calculations. Includes cash and food-based programs.

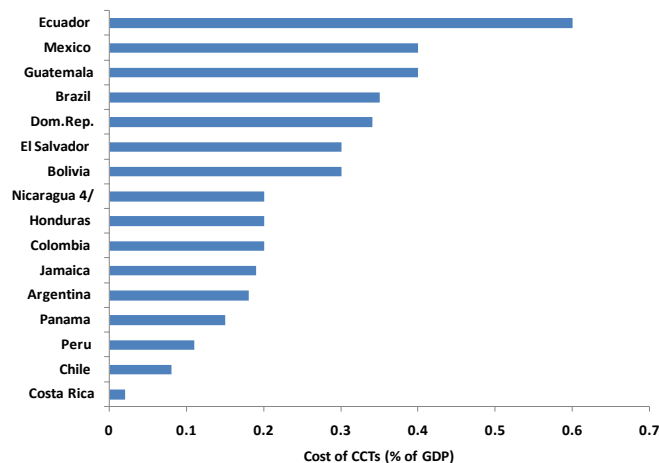
¹⁴ Barros et al (2006) found a strong causal link between *Bolsa Familia* and the recent reduction in Brazil's Gini coefficient.

Table 4: LAC Gini Coefficients and the Income Share of the Lowest Quintile, 1987-2005

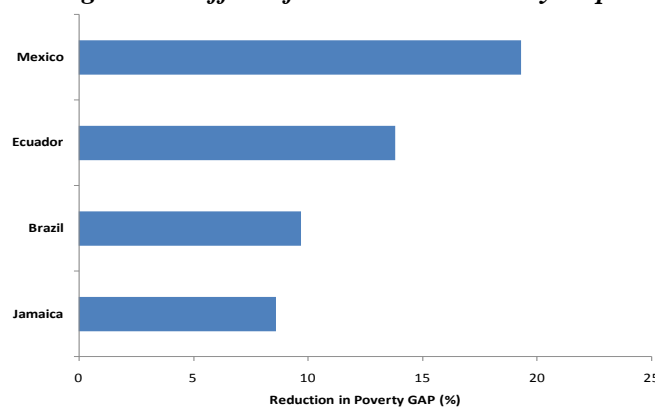
Country	Gini Coefficient			Income Share Lowest 20%		
	1987-1993	1994-2000	2001-2005	1987-1993	1994-2000	2001-2005
Argentina	45.4	49.2	51.8	4.6	3.8	3.1
Bolivia	42.0	58.1	60.1	5.5	1.7	1.5
Brazil	60.2	59.2	57.9	2.4	2.5	2.6
Chile	55.9	55.3	54.9	3.5	3.5	3.8
Colombia	52.7	57.6	57.5	3.3	2.8	2.6
Costa Rica	46.3	46.9	49.3	4.0	4.1	3.8
Dominican Republic	50.9	50.1	51.1	4.2	3.8	4.0
Ecuador	50.5	52.8	N/A	3.3	3.3	N/A
El Salvador	49.0	51.4	52.4	2.4	3.3	2.7
Guatemala	58.9	55.3	52.4	2.5	3.4	3.4
Haiti	N/A	N/A	59.2	N/A	N/A	2.4
Honduras	57.1	53.3	53.8	2.8	3.2	3.4
Jamaica	40.8	42.6	47.4	5.8	5.9	4.9
Mexico	53.1	49.8	47.9	3.6	4.1	4.3
Nicaragua	50.4	45.2	43.1	4.2	5.3	5.6
Panama	56.8	54.6	56.4	2.1	2.6	2.4
Paraguay	39.7	57.5	58.2	5.8	2.2	2.3
Peru	43.9	47.0	53.2	5.6	4.1	3.4
Uruguay	42.3	44.5	45.3	5.4	4.7	4.6
Venezuela, RB	46.4	48.5	48.2	4.5	3.7	3.3

Source: World Bank (2008b).

Figure 16: Cost of CCT programs (% GDP)



Source: World Bank staff estimates based on country data.

Figure 17: Effect of CCTs on the Poverty Gap

Source: Based on Fiszbein and Schady, 2009.

Workfare programs as a short term crisis response

As noted above, CCT programs are not the only type of cash transfer used widely in LAC. Workfare programs are implemented in crisis situations with the explicit goal of ameliorating rising unemployment, usually in urban areas. Such programs in LAC include *Jefes* in Argentina, PLANE in Bolivia, *Empleo en Acción* in Colombia, *Construyendo Peru* in Peru, PET in Mexico, and PANES in Uruguay. Such programs provide temporary full-time or part-time employment to adults, and sometimes have additional qualifying rules. For example, in Argentina, beneficiaries must have dependents, in Colombia, they must be qualified as poor under the country's proxy means test system, and in Mexico, they must live in a poor rural area. Benefit amounts vary considerably – from \$45 a month in *Jefes* (Argentina) to US\$153 in *Construyendo Peru*, but they are generally much larger than those paid under CCT programs, making workfare an expensive policy option. For this reason, coverage is normally limited to around 2 percent of the economically active population (EAP). However there are some exceptions. For example, *Jefes* in Argentina reached 13 percent of the EAP, and PANES in Uruguay reached 7.2 percent. Not surprisingly, these are the most expensive workfare programs in LAC, accounting respectively for 0.8 percent of GDP and 0.5 percent of GDP, compared with around 0.2 percent in the other cases.

Ideally, workfare programs should pay less than the market wage, to avoid distorting labor market incentives and should be anti-cyclical, being gradually eliminated as the recovery begins. However, because of labor laws, many workfare programs in LAC have to pay the minimum wage, which is often set well above the (informal sector) market wage for unskilled labor. As well as making workfare programs expensive, this also increases the risks that workers will be attracted away from private sector jobs and will then be reluctant to leave their workfare jobs, as they will have little chance of earning similar wages elsewhere. As a result, in spite of governments' intentions, it has not always been easy to keep program membership temporary, since workers have put pressure on the governments to allow them to continue in these jobs. However, some countries, such as Argentina, have been able to make the transition to more sustainable programs.

Interest in workfare is being revived in the context of the current global financial and economic crisis, which makes it important to ensure that lessons have been learned from previous experiences. Evaluation evidence suggests that their targeting was not strong – especially when compared with CCT programs – but they generally 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 for women. (Landa and Lizarraga, 2007). In Colombia, *Empleo en Acción* increased the consumption of beneficiary families by 9 percent (Colombia, *Departamento Nacional de Planeación*, 2004).

We conclude that workfare is a viable option to provide urban safety nets for informal sector workers during downturns and crises. However, since these programs have achieved modest impacts at quite high costs, they should be kept small and temporary. Wage levels should be kept as low as is legally feasible, to allow the program to assist the largest possible number of beneficiaries. Wherever possible, they should be linked to training opportunities and active labor market policies to help their beneficiaries find permanent employment. We return to this point below.

Challenges facing income support programs

The positive effects of recent developments in LAC's income support programs, documented in the previous sections, have been considerable. But there are also concerns that income support may give rise to moral hazard by undermining incentives to work and leading to welfare dependency. Such effects can arise when eligibility for benefits depends on being unemployed. As with the case of non-contributory SI programs (above), the value of the benefit then becomes a marginal tax on income earned in the formal sector. This can lead beneficiaries to stop looking for work or to bend the rules by working in the informal sector while also claiming the transfer.

However, this problem does not apply to either of the main classes of transfer programs that exist in LAC—CCTs and workfare. In most countries, eligibility for a CCT is based on a proxy means test that evaluates asset endowments and is updated infrequently. There is thus no implicit marginal income tax that might discourage their work effort. In the case of workfare programs, beneficiaries must either 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 OECD countries.¹⁵

Programs that include no unemployment test may still erode incentives to work, but only to the extent that benefit recipients have such a low preference for additional marginal consumption that they are not prepared to trade their leisure for increased consumption beyond the amount financed by the transfer and therefore would prefer to remain idle rather than to work. On the other hand, as already noted, transfers may also give households the additional liquidity that they need to make small investments, which may actually “crowd in” an increase in the work effort (Ellwood, 1988). The size and direction of the net labor supply effect would then be an empirical question.

The empirical evidence suggests that LAC's CCT programs have little or no disincentive effect on the adult labor market. Skoufias and di Maro (2006) found that *Progresá* 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.¹⁶ Leite (2006) simulated the effect of Brazil's *Bolsa Família* on adult work effort and found

¹⁵ 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 (Aid for Families with Depended Children 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 USA and Europe, the purpose of which was to eliminate incentives for recipients of income support to pursue unemployment or informality. In the USA, the Temporary Program for Needy Families (TANF) incorporated many design elements that encouraged beneficiaries to work. As a result of these reforms, open unemployment and informal employment (“moonlighting”) were drastically reduced.

¹⁶ Male program beneficiaries worked on average six hours less per week than non-beneficiaries, but the total number of hours worked increased for both the control and intervention group of the study, so these results are not easy to interpret. The authors believe that they may reflect a drought that afflicted the study areas.

that the program had had little impact. However, 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 (Skoufias and Parker, 2001 and Schady and Araujo, 2008).

The evidence on workfare programs suggests that, as expected, they affect the interplay between formality and informality and labor force participation rates. Design factors play a key role in these outcomes. Perry et al. (2008) found that the *Jefes* program in Argentina created incentives for its beneficiaries to work in the informal sector, suggesting that some beneficiaries were able to “moonlight” in order to earn income in addition to receiving the transfer. This underlines the importance of enforcing work requirements or other similar measures.¹⁷ The evidence also suggests that if workfare programs pay high wages, then workers will be dissuaded from looking for other employment. Galasso and Ravallion (2003 and 2004) showed that the large benefit provided by *Plan Trabajar*, the predecessor to the *Jefes* program, had a negative impact on labor supply, but when the benefit was reduced in 2002, this effect came to an end.

If anything, the causality runs in the opposite direction. Rather than leading to an increase in unemployment or informality, most of LAC’s targeted income transfer programs are a response to precarious labor market conditions and incomplete social insurance coverage for poor households which result from policy failures elsewhere in the economy. There are, nonetheless, several issues that need to be addressed to improve their impact. First, there is a need to strengthen the coordination between CCTs and the supply of health and education services to the households that benefit from CCTs. Second, many income support CCTs and similar programs need to modernize their procedures for enrolling and “graduating” beneficiaries in a timely fashion. Third, models of targeted income support need to be developed that will be more effective in urban settings, providing services to increase employment opportunities. Fourth, the crisis response capacity of the targeted systems needs to be further strengthened. Finally, there is also a need to guard against the irresponsible expansion of CCT programs for political motives, especially in urban settings and especially in pre-electoral settings. This can best be achieved by strengthening the governance arrangements of the programs through the definition of clear eligibility rules, robust beneficiary registers and transparent financial administration.

Challenge V: Improving access to good quality jobs

CCTs, in combination with good education and health programs, can help to strengthen human capital endowments for poor families and thus improve their future earnings potential. But in the end, the return on investments in human capital depends on the quality of health and education services and on an individual’s job and earnings when he or she enters the labor market. Unfortunately, in LAC, many of the jobs created in recent years are low quality, informal sector jobs, characterized by low productivity and earnings and by insecurity, and which employ mainly unskilled workers and young people. A reflection of this is that in many countries GDP per capita has been growing mainly as a result of an increase in the share of the employed population in the total population and not because of an increase in the average productivity of workers (see Figure 18).

Many of the causes of these poor labor market outcomes lie outside the sphere of social protection. They include problems in the business environment, which undermine incentives to invest, to adopt new technologies, and enter new product markets. Nevertheless, social protection policies can also 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

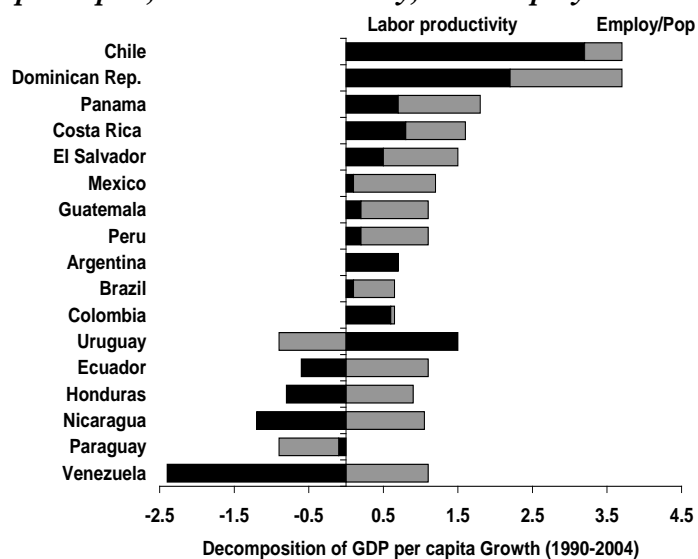
¹⁷ This effect was strong in 2003-04, when the *Jefes* transfer was almost equal to the market wage, but during subsequent years, when the differential widened, *Jefes*’ effect on informality disappeared.

contracts, and by ensuring access to adequate income protection programs. In addition, well-designed active labor market programs (ALMPs) can help to address skills mismatches arising from the lack of information among labor market participants or from structural imbalances between the supply and demand of skills. However, regrettably, few of LAC's income protection systems and ALMPs are yet up to this task.

As discussed above, to smooth consumption for workers who lose their jobs, most of LAC's income protection systems still rely on severance pay, which is ineffective, and the coverage of unemployment insurance programs or individual unemployment savings accounts is very low.

At the same time, active labor market policies (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, or to an understanding of the best ways to correct them. The systems are fragmented: many diverse institutions are involved in designing and implementing programs, often with no coordination. The main focus has been on training programs, which tend to be supply driven and which lack institutional arrangements to align the incentives of program managers, job-seekers, and employers. Intermediation and job search assistance programs are severely under-developed, and monitoring and evaluation systems are generally weak.

Figure 18: GDP per capita, Labor Productivity, and Employment Growth



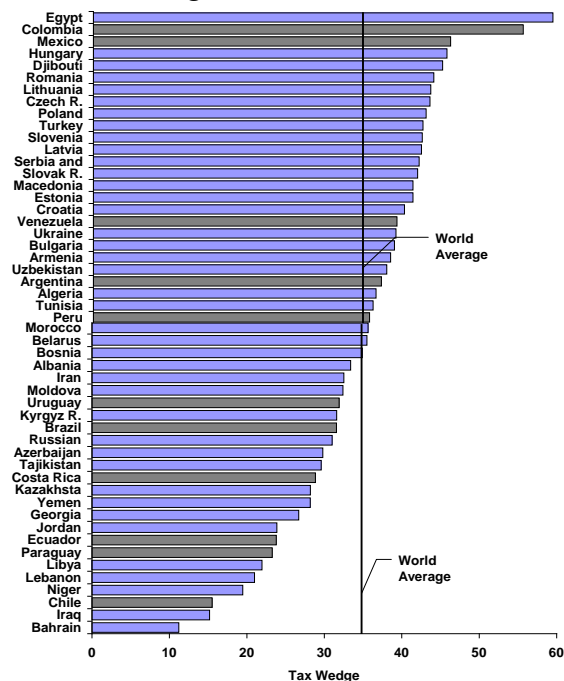
Source: Authors' calculations.

There has also been a tendency to focus on providing services to 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. They mainly serve workers who have completed their secondary education. Poor and unskilled workers are less likely to benefit. As noted in the previous section, many countries have created workfare programs to address fluctuations in labor demand and provide short-term consumption smoothing support for uninsured workers, but these are costly, have limited coverage, and are rarely coordinated with ALMP training and job search services.

Unnecessarily high tax wedges also constrain access to good 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 19). Often, this reflects the proliferation of

non-essential benefits, such as recreational facilities, child care, or family allowances. In countries with unsustainable Pay-Go pension systems (such as Brazil, Nicaragua, or Uruguay), in the absence of reform to bring benefits back into line with contributions, there is a risk that the tax wedge will need to increase even more, as there will be pressure to increase contributions and payroll taxes or to increase income taxes to fund the deficit. The alternative would be a default in the payment of the promised benefits. The aging of the population will also put pressure on health expenditures and on the required contribution rate in social health insurance systems.

Figure 19: Tax Wedges in LAC Countries and the World



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:

$$tw = \frac{(w + w\beta_e) - (w - w\beta_l - w\tau)}{w + w\beta_e} = \frac{\beta_e + \beta_l + \tau}{1 + \beta_e}$$

where w is the gross wage, β is the contribution rate paid by the employer (e) and the employee (l), and τ 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.

Source: World Bank staff calculations based on country data.

II. A Vision for Social Protection in LAC

This section lays out a conceptual framework for understanding the objectives and elements of a social protection system, the interactions between programs and with the economy as a whole. The framework is then used in the following sections to lay out a proposed way forward for improving the coverage and adequacy of SP in LAC.

Conceptual framework: understanding the social protection system

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

Objectives

Smoothing consumption and *preventing poverty* are the well-recognized objectives of any social protection system.¹⁸ When a shock materializes, policies need to be in place to enable individuals and households to replace part of their income and, thus, smooth – or at least avoid large reductions in – their consumption. In the case of low-income individuals, the SP system must not only protect them from shocks but also possibly provide them with 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* as a way to increase individuals' earnings capacity, reduce their exposure to risk and help them to manage idiosyncratic risks.¹⁹ 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.²⁰ This helps to reduce individuals' 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. At the same time, having access to more productive activities with higher incomes gives individuals more ways to devise risk prevention strategies.

There are clear tradeoffs among the three objectives. If the social protection system fails to promote human capital as a way to reduce risks and encourage private/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 due to their lack of access to social insurance programs.

To achieve the three objectives described above, the framework distinguishes three types of policy choices: (i) that of instruments or programs; (ii) that of financing mechanisms; and (iii) that of implementation arrangements. It acknowledges that several combinations of these three kinds of policies are possible, which is why there is such a diversity of social protection systems across the region. It also acknowledges that each policy choice will have effects on the behavior of individuals,

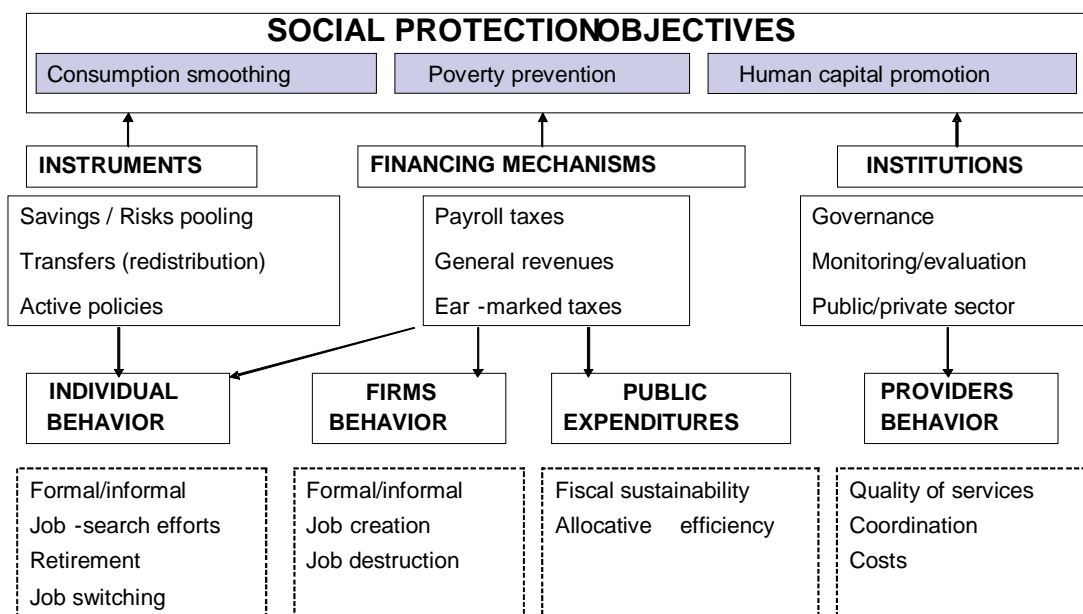
¹⁸ For earlier definitions of social protection, see Ehrlich and Becker (1972). See also Holzmann and Jorgensen (2000) for a discussion of the Social Risk Management Framework and de Ferranti et al. (2000) for a discussion of the Comprehensive Social Insurance Framework.

¹⁹ Idiosyncratic risks are those that might potentially 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.

²⁰ This study deals with access to jobs but not to credit.

employers, and providers, and on the efficiency of public spending (see Figure 20).

Figure 20: A Conceptual Framework for Social Protection



Source: Authors' construction.

Instruments

The available instruments to deal with the first two objectives are social insurance programs which promote savings and risk-pooling (insurance) and targeted transfers (redistribution)²¹. Savings and insurance are alternative forms of consumption smoothing²², and targeted transfers are the main poverty prevention instrument but may also form a part of a well-designed social insurance system to help ensure access to coverage for low income households. The savings arrangements discussed in this report include defined-contribution mandatory pensions, unemployment individual savings accounts, and health insurance savings accounts. In all of these cases, individuals save in individual accounts to finance their consumption when their income falls as a result of unemployment, disability, or retirement or when their expenditures increase as a result of sickness. Risk-pooling arrangements include pension annuities (which respond to the unpredictability of an individual's lifespan after retirement), unemployment insurance or severance pay, and health insurance. In these arrangements, individuals and employers 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 individuals 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 programs.

²¹ Voluntary savings and insurance which aim to complement the coverage in mandatory systems through private arrangements – the so called “third pillar”- are not dealt with in this report.

²² As analyzed in the comprehensive social insurance framework developed by Ehlich and Becker (1972) the optimal choice between savings and insurance 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 is the inclination towards savings; and vice versa. Thus, the high probability of survival beyond retirement age argues for a strong savings element in pensions systems, while the high cost and low probability of some extreme health events argues for an insurance response.

The framework distinguishes between *systematic* and *non-systematic* redistribution and between *explicit* and *implicit* redistribution. In pure savings arrangements, there is no redistribution: each person's savings are their own. In a pure risk-pooling arrangement, the redistribution of income is non-systematic. All members of the risk pool face the same risks so they have the same probability of receiving a transfer. As was seen in Section I, however, in the typical LAC social insurance system all individuals do not face the same balance between contribution rates and risks, and there are also rules such as minimum benefits levels, which 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.

However, 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 (see below). Explicit redistribution, on the other hand, is targeted to specific groups, the level of the transfer is defined upfront, 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 risks by improving labor market outcomes, the instruments that are discussed in this report include conditional cash transfers and active labor market programs (ALMPs). Conditional cash transfers 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 skills of potential workers with the labor market's demands. These programs include training, retraining, and skill recertification programs (which aim to increase the *employability* of individuals) and programs for labor market intermediation, job search assistance and relocation grants (which aim to overcome *job search constraints*).

Financing mechanisms and Institutional Arrangements

A social protection 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 social protection. Most social protection systems in LAC are financed in three ways: (i) by payroll taxes (paid by employers) and social security contributions²³ (paid by employees and collected in the workplace); (ii) by general government revenues; and (iii) by earmarked taxes. Payroll taxes and social security contributions mainly finance social insurance programs (such as pensions, unemployment benefits, and health services), although several countries also use the payroll to finance ALMPs.

General revenues are best used to finance social assistance programs, such as conditional cash transfers and health expenditures for those not covered by social security. However, they are also often used in LAC countries to cover deficits in social insurance systems where the contributions of plan members are not enough to cover the promised benefits. In countries that have introduced funded pensions, general taxation is also 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 social insurance programs.²⁴

In addition, any social protection 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

²³ When social security contributions finance redistributive social protection programs, at least part of the contribution can be considered a tax.

²⁴ Arguably, earmarked taxes are part of general government revenues.

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 above, 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, very 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. More generally, they can generate negative externalities (such as 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 pre-paid, to remove any financial barriers to access at the moment when care is needed. It also follows that health benefits in social insurance systems are normally provided not in cash (the reimbursement of expenditures) but in-kind (the direct provision of services by an approved provider). The effectiveness of any social protection 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 policymakers 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

The framework used in this study also 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 was analyzed in some detail in section I, 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 respond 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, encourage informality.

In general, the less transparent are 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 at the expense of the poor).

The social protection system also influences *the behavior of firms and employers* who react 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 can also affect a program's funding. For instance, a good 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 insurance, the way in which insurers contract with hospitals affects the cost of services and the quality of care. In many health systems, financing and service provision are organizationally integrated. NHS systems receive a budget from the government to operate clinics and hospitals. Social health insurance systems often combine insurance and service production functions and the efficiency of the system might be enhanced if these two functions were separated (see discussion in Section III).

Finally, social protection 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 used for 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 tradeoffs.

Putting the vision into practice

This section lays out five key steps which would help LAC's SP system to turn the right to social protection into a reality for millions of workers across the region.

- *Open up contributory social insurance 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 within SI programs.
- *Reform subsidy systems for social insurance*, by making solidarity transfers transparent and compatible with incentives to work and save. Instead of opaque cross-subsidies within SI programs and separate, second-class non contributory programs for the poor, the region should move towards unified programs, with transparent subsidies that are targeted based on means and tapered so they gradually decline as income rises. Ideally, such subsidies should be tax-funded, to avoid distorting the incentives of other workers through contribution rates that are misaligned with their benefits packages.
- *Improve the coherence of SI systems* by rationalizing benefit packages and harmonizing or integrating parallel programs and exploiting opportunities to share savings and insurance pools between risks. There is also a need to rationalize the interactions between social insurance, safety net and active labor market programs.
- *Deepen the anti-poverty social safety net* for workers and households in extreme poverty

who have no capacity to participate in contributory social insurance, even with the help of subsidies. A key challenge is to strengthen the impact of safety net programs on human capital investments in education, health and nutrition that can help poor households to break out from the intergenerational transmission of poverty.

- *Facilitate access to better jobs* through strengthened active labor market programs for low-income/low-skilled workers. Such programs can help improve employability, facilitate job search processes and increase labor mobility. This, in turn, can increase the level and stability of earnings and reduce economic vulnerability and thus relieve pressure on other elements of the SP system.

Opening social insurance access to all

The central goal of the suggested strategy is to open up access to contributory social insurance for all workers, including those in the informal sector, whom the government is not able to oblige to contribute through mandatory arrangements.

The suggested approach is to continue financing social insurance from beneficiaries' contributions (and employers' contributions, when available). This would remain mandatory in the formal sector²⁵. At the same time, contributory social insurance would be opened up to informal sector workers, on a voluntary basis. These would not be special, second class programs – they would be the same programs available for the formal sector, with the same basic packages of contributions and benefits.

The expansion of the contributory social insurance system will be difficult unless benefits are related to contributions. For this reason, contribution rates and benefit formulas/packages should be revised to remove “taxes”, that is, contributions greater than the value of the expected benefits. Only then would SI systems be potentially attractive to all workers and be able to accommodate the varied contribution rates and densities that are viable for excluded workers without compromising their financial sustainability. This would help reduce workers' disincentives to participate in social insurance.

Expanding the coverage of contributory systems to those working in the informal sector or in rural areas in the agricultural sector presents policymakers with several challenges. These workers are often employed in small firms or are self-employed. They are often unskilled, with low incomes and limited savings capacity. They are often 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.

If they aim to offer services to these workers, SI programs will need to adopt appropriate rules and payment and contribution collection systems. First, as argued above, participation should be voluntary, not mandatory. It is neither possible nor desirable to enforce a mandate on this population. Second, in many cases, these workers are not wage-earners, so contributions would need to be set in the form of flat payments, not as proportions of wages, and contribution scales would be needed to accommodate individuals with different savings capacities. Third, a proactive mechanism would be needed to market the insurance programs and collect contributions (for example, mobile agencies operating in markets or in remote geographical areas). Fourth, transaction costs would have to be minimized, since for many contributions are likely to be small.²⁶ Finally, restrictions on vesting periods for the payment of benefits would need to be relaxed, since many plan members may not be able to achieve high contribution densities.

²⁵ This proposal is therefore 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 Text Box 2, below.

²⁶ See Sluchinsky (2009) for a discussion of new systems that can facilitate registration and the collection of contributions.

Text Box 2: The limitations of funding social insurance entirely from general taxation in LAC

Previous studies have argued that it is ineffective to finance social insurance thorough payroll taxes on employers and workers SI contributions, because of the problems of informality and the problem with the design of parallel non-contributory schemes discussed in Section I of this report.²⁷ This has led to proposals for a radical shift towards systems with no beneficiary contributions which would offer basic benefit packages (e.g., health, pensions, or unemployment) to all citizens or residents, regardless of their income level or where they work. The costs would be financed entirely from general revenues and/or earmarked taxes. Individuals wanting extra protection or insurance would be free to enroll in voluntary, complementary plans that could be managed by the public or private sector.

Although it is attractive in principle, this proposal has not achieved a great deal of traction with policy makers in LAC. This suggests that such a radical change in the structure and financing of social insurance may not be feasible in many LAC countries in the short to medium term.

In practice, the proposal to move entirely to tax-based financing for social insurance faces several potential drawbacks in LAC, especially for the elements of social insurance which require strong savings elements, such as pensions. Inevitably, there would be a tendency to structure benefits based on a “lowest common denominator” and leave additional savings and insurance contributions to voluntary effort. As a result, it would be likely to imply a considerable reduction in the level of benefits, compared to those presently given by many contributory social security systems.

This problem is compounded by the low level general tax revenues (such as income taxes or consumption taxes) in many LAC countries. Countries with a strong element of tax-based finance for social protection (for example, in the EU) 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 social insurance and to be concerned about the opportunity cost of transfers that subsidize the entire population, regardless of income²⁸. Depending on the efficacy of the tax system, these transfers can be regressive.

It is also likely that many employees will be reluctant to give up existing rights. At the same time, voluntary arrangements would be exposed to the standard problems of myopia – which justify government intervention in the first place.

Some of these problems can be addressed, in part, by operating through “aggregators” in the agricultural and services sectors. The social security institution could enroll workers and collect contributions through cooperatives or associations, to generate scale economies, reduce transaction costs, and facilitate access to financial services. In addition, as mentioned above, financial incentives would be 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 are discussed in more detail in the next section.

Reforming social insurance subsidy systems to remove implicit redistribution

Expanding social security coverage to all involves public subsidies because many individuals, such as low skilled workers in low productivity jobs, do not have enough savings capacity to cover the cost of the risks they need to insure. However, the way in which these subsidies are designed and financed matters a great deal. As discussed above, implicit transfers financed from pay-roll taxes and from excess social security contributions, which are at present the prevalent form of subsidy in many of

²⁷ See Perry et al. (2007) and Levy (2008) for a general discussion and Baeza and Packard (2006) for an application to health.

²⁸ If the budget and the set of taxes that finance it are taken as given, a shift to a system where basic SI benefits are subsidized for all would induce a regressive redistribution of income.

LAC's SI systems, can be regressive and costly and can distort incentives. Removing implicit redistribution from the contributory systems is thus important for three reasons: (i) to target the available subsidies to those individuals who need them most; (ii) to reduce unintended behavioral consequences: targeted transfers affect fewer workers, with lower productivity, reducing the risk of production losses; and (iii) to make financing more efficient, for instance, by reducing the tax-wedge.

The alternative is to move to a system of *explicit*, targeted subsidies which, 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 would contribute to the financing of the benefits in proportion to their income. High-income workers would pay in full the contributions and/or premiums corresponding 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 their benefits and/or contributions²⁹. The subsidies would also constitute a financial incentive to enroll in social security.

A safety net of separate, fully subsidized social assistance or income support programs would continue to meet the needs of the long-term poor who are unable to contribute anything.

Removing implicit redistribution. The removal of implicit redistribution simply means that in the core social insurance system, whether it is funded or pay-as-you-go, everyone's contributions would be set to pay for the expected cost of the benefits that they will receive. However, this policy *does not* imply that redistribution would disappear or that reformed systems should lack all forms of solidarity. As was argued above, redistribution is important for equity and efficiency reasons (externalities), but the suggestion of this report is that wherever feasible, it should be pursued separately (see next section).

The implication of this change, in practice, is that social insurance would be based either on savings arrangements (so benefits are determined by the savings that individuals accumulate) or non-redistributive risk-pooling (so individuals would pay premiums that reflect the cost of the benefit and the risk of the insured event materializing). The next section will discuss how these general concepts could be applied to pensions, unemployment, and health insurance. It is important to emphasize, that this approach would also help to improve programs' financial sustainability. Savings arrangements are sustainable by definition – they pay back what workers have accumulated in their savings accounts (whether funded or notional). Risk-pooling arrangements can also be sustainable, so long as the insurance premiums cover the expected costs of the benefits provided. Nevertheless, in some cases, governments will also need to deal with existing unfunded liabilities. This is the case in most pensions systems with pay-as-you-go financing. Changes in benefit formulas can prevent the accumulation of new unfunded liabilities but will not erase the current debt.³⁰ If “acquired rights” are preserved, the government should acknowledge this (for instance, by issuing non-tradable bonds to the pension institution, to be gradually repaid from general revenues).

There are also unfunded liabilities of employers in severance pay systems. If the government were to mandate a switch to unemployment savings accounts that included these historical liabilities, this could be very costly for employers.³¹ However, acquired rights could be “grandfathered” so that only new benefits would accrue in the savings accounts.

²⁹ Or alternatively, to top up benefits if they do not reach an acceptable minimum, based on the worker's own contributions.

³⁰ They could only eliminate accumulated imbalances if contributions were to be set above the value of benefits for the present-day contributors, which is not recommended here.

³¹ See Kugler (2005).

Eligibility conditions and benefits levels for explicit transfers. Eligibility for subsidies should ideally be based on earnings and savings capacity - not on workers' occupation, economic sector, or whether they have a formal or informal job. As discussed in Section I, 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 and/or reduce contribution densities (see Robalino et al., 2009a). Similarly, large unemployment subsidies (and/or long-lasting eligibility for benefits) are likely to create moral hazard and lengthen unemployment spells, thus increasing costs and compromising the program's sustainability (see Robalino et al., 2009b).

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 and/or unemployment benefits equal to the minimum wage would be likely to reduce incentives for work. In general, the recommended approach is to start with modest benefits, since scaling programs down is politically more difficult than scaling them up.

In all cases, when eligibility conditions are being designed, likely behavioral responses and cost implications should be taken into account. For example, the retirement age is an important factor in the design of pension transfers. It needs to be high enough not to produce incentives for workers to retire early or reduce the amount that they work. Indexing the retirement age to life expectancy – so that as people live longer, they also work longer - can considerably reduce the long-run costs of social pensions (see Piggot et al., 2009). Vesting periods are a less effective tool for controlling costs, since 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, it is recommendable that means tests be used to allocate subsidies. There are two (related) reasons for this. First, for a given a level of benefits, means tests can reduce the costs of the program. Second, for a given budget, means tests make it possible to give higher benefits to those who need them most. A recent study of Niger, Kyrgyz Republic, Panama, and Yemen showed that, given the budget constraints faced by those countries, universal pensions would be “spread too thin” and would fail to have much impact in terms of reducing poverty (see Grosh and Leite, 2009).

However, as discussed in Section I, the use of means tests automatically creates an effective marginal tax rate (EMTR) on the income of individuals close to the eligibility line, which might affect 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 the problem will depend on the amount of the transfer and the specification of the income cut-off point. The greater the transfer amount and the higher the income cut-off point (so that more people are potentially eligible), the bigger the likely effect.

One solution to this problem is to introduce tapered subsidies with gradual “claw-backs”, so that EMTRs are reduced. Calculations for Chile suggest that optimal claw-back rates would be less than 50 percent. However, (for a given benefit level) the lower the EMTR, the higher is the cost of the program. Thus, policymakers will need to assess the tradeoff between incentives (a lower EMTR) and fiscal costs (see Piggot et al., 2009).

Ex-ante versus ex-post transfers. Transfers targeted to workers with limited savings capacity, to subsidize their access to social insurance for pensions, unemployment benefits, and health care, can take the form of *ex-ante* matching contributions (to complete the required premiums) or of additional *ex-post* non-contributory benefits (to enable individuals to attain a 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*). The same goes for health: governments could subsidize insurance premiums or health expenditures.

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 of matching 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 non-behavioral models suggest that (depending on the value of the take-up rate/matching elasticity) matching contributions could cost up to 20 percent less (in present value) than social pensions (see Palacios and Robalino, 2009). Behavioral models³² suggest that moving from a minimum pension guarantee to matching contributions could increase contribution densities while reducing fiscal costs considerably (see Robalino et al., 2009a for a discussion of the case of Brazil). For unemployment transfers, the main advantage of matching contributions is that they give workers incentives to work. If workers can keep the subsidies regardless of whether they work or not, unemployment spells could be reduced and a system based on matching contributions could therefore cost less.

Unfortunately, international experiences with *ex-ante* transfers are limited. 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 401K plans in the USA, where matching contributions have been shown to increase contributions to voluntary pension plans. However, these results cannot be extrapolated to the informal and agricultural sectors in middle-income and low-income countries. No country has yet implemented *ex-ante* unemployment insurance transfers. The closest is the Korean UI system, where workers who find jobs before their unemployment benefit entitlement ends can claim part of the balance, but the impact of this on the length of unemployment spells 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 social insurance premiums are significant, so the experiences of those countries that are implementing such programs should be closely 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 externalities that would be associated with 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 can be financed by taxes (including VAT, consumption, income, and imports) and/or income from the exploitation of natural resources. Some countries (such as France) use earmarked taxes to finance social security. However, such earmarks create rigidities 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.

³² Behavioral models are those which take into account the predicted responses of workers to the incentives in the insurance system.

As discussed in Section I of this report, the problem with using payroll taxes to fund subsidies for other workers is that they increase the tax wedge above the amount needed to cover the social insurance of the worker in whose name they are being levied. As also discussed Section I, tax wedges are already 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. However, it is also important to understand the opportunity cost of the resources involved. Implementing a large income transfer program might require the government to spend less on education, health, or infrastructure. Such opportunity costs are difficult to quantify, but they need to be given careful attention by policymakers.

Improving the coherence of social protection programs

The third challenge is to improve the coherence of social insurance by rationalizing benefit packages, integrating and harmonizing parallel programs, exploiting opportunities to share savings and insurance pools between risks, and focusing more on interactions with other types of insurance, safety net and labor market programs. This section presents suggestions on how to advance with this agenda. It looks first at measures to improve the internal coherence of social insurance by working to harmonize benefits packages and simplify and unify institutional and programmatic structures. It then discusses opportunities for linkages between different types of social insurance (such as pensions and unemployment insurance, for example) and opportunities to improve the interactions between social insurance, safety net and active labor market programs. This second level of integration would have the following advantages: (i) it would reduce costs by sharing an individual's savings pools across risks (such as unemployment and old-age income security); (ii) it would avoid adverse interaction effects between social insurance programs; and (iii) it would exploit any positive spillover effects between programs.

Harmonizing the mandates (benefits packages) of social insurance programs. For each social insurance program, the first step would be to define its objectives, in terms of the coverage and benefits to be offered. There is no single "right" set of social protection mandates. The choices made will vary from country to country, reflecting social preferences about the appropriate balance between the responsibility of individuals vis-à-vis that of the government.

In general, the factors to be taken into account when defining the mandates of social insurance programs include *benefit adequacy*, *program efficiency* and *affordability/sustainability*. Benefits need to be meaningful and 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*). However, they should not reach such high levels that they discourage individual savings or distort labor supply (*efficiency*). Nor should the subsidized element of the benefits put an unsustainable burden on public finances (*affordability or sustainability*).

Clearly, these thresholds are difficult to define *ex-ante*. Stakeholders need to discuss the economic impacts of alternative mandates, which will vary with 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 any informal social protection arrangements. Richer countries can afford more generous social insurance systems than can poor countries, because they have more fiscal resources and because a smaller proportion of households will need subsidies.

The mandates of *pensions and unemployment insurance programs* (whether funded or Pay-Go) can be characterized by three policy variables: (i) a targeted income replacement rate; (ii) a minimum benefit level; and (iii) a ceiling on covered earnings. These three variables determine the benefits that

individuals will receive.³³ 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 retirement would have to make additional savings outside the mandatory system (see Figure 21).

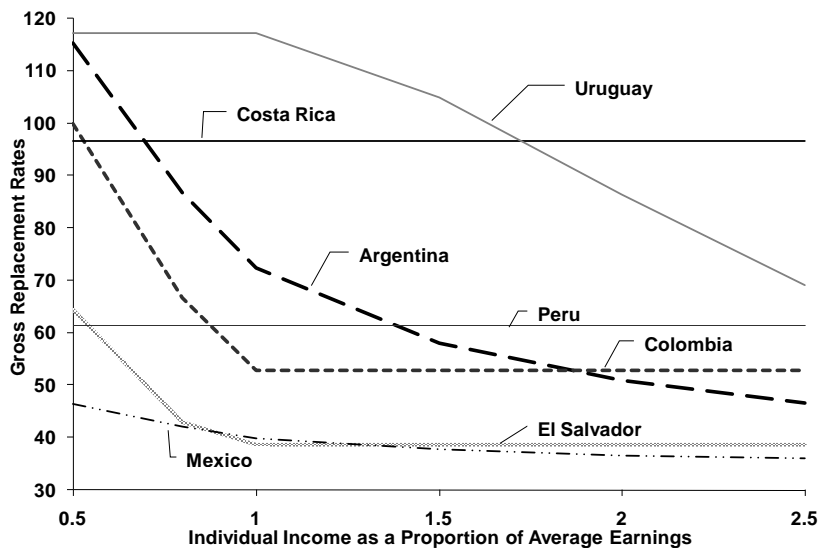
Characterizing the mandate of the *health insurance* system is more complex, but similar principles apply. In this case, the mandate is generally defined in terms of the share of the cost of a given health intervention that is covered by the insurance system. The program must therefore define: (i) the package of eligible health interventions (benefits) that are covered; and (ii) the proportion of the costs it will pay for³⁴. Decisions about the share of health expenditures covered by the social insurance system and the part to be covered by the individual (out-of-pocket, or through voluntary insurance arrangements) are social choices. For example, if the policy goal is to ensure that individuals preserve a minimum level of income after covering the cost of the health shock, policymakers might apply higher co-payments or deductibles to high-income individuals.

The design of health insurance systems also needs to take into account the existence of positive externalities associated with public health interventions and negative externalities from the delayed treatment of morbidities. To minimize the risk that anyone would be excluded from preventative interventions, it might make sense to subsidize part of the cost for everyone, regardless of their income. Negative externalities from contagion when the treatment of infectious diseases is delayed, or from the emergence of complications and increased costs when traumatic injuries are not treated rapidly, have implications for the choice of financing arrangements: pre-payment is often preferable in order to eliminate the risk that liquidity constraints might prevent effective access to services at the moment they are needed.

³³ In a funded system, the savings amount should be chosen taking account of these factors. For the case of a Pay-Go system, given the targeted replacement rate the policymaker must set the contribution rate accordingly.

³⁴ This is referred to technically as the reimbursement rate and is analogous to the replacement rate in pensions and unemployment insurance.

Figure 21: 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.

It is also important to reduce uncertainty about how social insurance 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 for the adjustment of benefits to compensate for inflation to be discretionary. Even with modest inflation, the real value of benefits that are fixed in nominal terms can change radically over time. Similarly, in an inflationary climate, having a ceiling on covered earnings, 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 fix parameters in real terms – for example, by indexing the benefit to average earnings. This protects benefits against inflation and leads to automatic increases in real benefits, in line with standards of living.

In terms of *institutional organization*, the suggestion of this report is that countries should look for ways to rationalize multiple programs and move towards integrated pensions, unemployment benefits, and health insurance systems.

One possible long-term strategy to promote *horizontal integration* (that is, integration between schemes that cover the same risk) is to mandate new generations of workers to enroll in a common insurance system, while allowing complementary occupational plans to exist on top of the basic, mandatory programs. Meanwhile, policymakers could work to harmonize benefit formulas and eligibility conditions across programs. Developing arrangements to allow *portability of benefits* across schemes would be a sensible short-term measure, which is likely to encounter little resistance from stakeholders. The 1996 CARICOM social security portability agreement facilitated labor mobility both within countries and across countries in the Caribbean regional labor market.

Coordinating policies between social insurance and social protection programs. As well as harmonizing all programs that address specific risks, it is also important to coordinate policies and programs within the SP system as a whole.

Sharing savings across risks. The economic and welfare benefits that can result from integrating social insurance programs are important. The pooling of the self-insurance component of programs can reduce the amount of savings needed to provide a given level of insurance compared with having separate programs, so common savings funds can increase welfare (see Orzag, 1999).

One example of pooled savings is the integration of unemployment benefits and pensions. Unemployment individual savings accounts (UISAs) normally make it possible to use the balance in a worker's individual account to finance his or her pension upon retirements; this is a natural feature of the design of UISAs. However, during a person's working life, surplus pension wealth cannot normally be used to finance unemployment benefits.³⁵ Yet the transfer of pension wealth to cover short term risks can facilitate workers' risk management throughout their lifecycles and reduce their contribution rates. If the rules allow surplus pension wealth to finance benefits, for any given level of unemployment benefits, employees/employers can contribute less and the government can subsidize less.

To implement this idea, countries with UISAs (funded or notional) could allow workers to continue to receive benefits (up to a limit) even if the balance in the unemployment savings account becomes negative and government subsidies run out. Workers would have two options to repay the borrowed funds: (i) to use part of their pension wealth, which would imply receiving a lower pension; (ii) to make additional contributions while still active in the labor market. Clearly, there would be a limit in how much pension wealth can be used, so that enough long term savings are preserved to finance an adequate pension (see Robalino et al., 2009b for a discussion on the optional level of borrowing).

Cross-effects between insurance programs. The performance of any social insurance program can be affected by the design of other social insurance programs. Individuals' behavior (such as the decision to work or not, the choice between a formal and an informal sector job, and savings decisions) are 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.

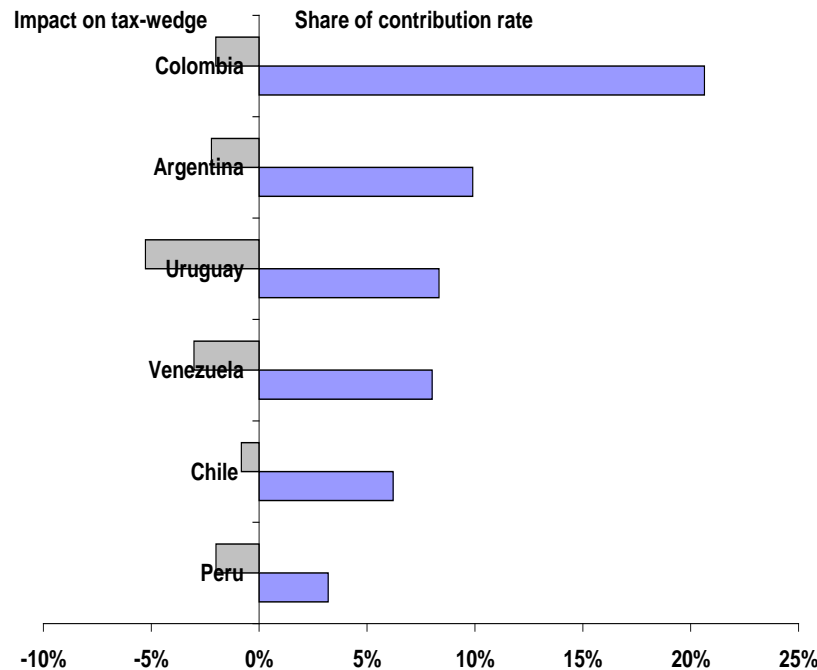
The first issue is to specify the bundle of benefits provided by the SI system as a whole. In many countries, this bundle goes beyond core benefits such as pensions (old-age, disability, and survivorship) and unemployment insurance, to include family allowances, maternity leave, sick leave, funeral expenses, child care, housing, and *ad hoc* programs, such as skills training and sports and recreation benefits (see, for instance, 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 the tax wedge. One possible option might be to limit the mandatory bundle to programs that cover social risks where it is expected that private arrangements would fail. This approach would limit the mandate of the social security system to health insurance, pensions (the

³⁵ An exception is Mexico where unemployed workers can withdraw from their individual pension accounts (AFORES) either 10 percent of the balance and 75 days' salary, whichever is the lower, but there is no connection to the unemployment savings accounts. Moreover, this type of withdrawal can only take place once every five years.

three types), and unemployment benefits.³⁶ This would improve incentives and reduce the contribution rate and the tax wedge (see Figure 21).

Figure 22: Share of Social Security Contribution Rate Allocated to Non-essential Benefits



Source: Authors' calculations.

Note: Non-essential benefits are those that are not related to pensions, unemployment insurance, and health insurance.

Policymakers should also be mindful of cross-effects between programs. For instance, a recent study for Brazil shows that the design of the income protection system affects pension contribution densities and retirement ages (see Robalino et al., 2009). The reverse is also true: changes in the pension system can affect contribution densities in the income protection system, benefit take-up rates, and, ultimately, 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 Robalino et al., 2009c).

Cross-effects between insurance and other programs. There are also potential gains to be made by coordinating social insurance and ALMPs and social insurance and social assistance programs.

Income protection benefits can give individuals an incentive to participate in ALMPs and intermediation services. This, in turn, helps intermediation programs to reach the critical mass of participants that they need to reach in order to be viable. Employers will only participate if there is a large pool of potential candidates and job-seekers will only participate if there is a large pool of potential job offers. 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

³⁶ 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 would be integrated with other targeted transfers in the social assistance system and financed out of general revenues.

beneficiaries invest their time in activities that will result in them getting a new job.

The main issue on the interface between social assistance and social insurance programs is how to improve the coordination of the design and implementation of transfers in the context of *dual* redistributive systems. The first layer would be a general social assistance system that acts as a safety net for *all* poor people. The second layer would include redistributive programs that made the transfer conditional on beneficiaries participating in the social security system. For this dual system to work, transfer amounts would need to be carefully calibrated. If non-contributory anti-poverty programs were too generous, then this would reduce incentives to participate in social security. On the other hand, if social insurance subsidies were too high or were available to the non-poor as well as the poor, they could be regressive (see Chapter 7 in Robalino et al., 2009c).

Deepening safety nets and facilitating access to better jobs

One of the objectives of any SP system is to promote human capital investments and facilitate access to earnings opportunities, and thus to increase savings capacity and reduce vulnerability, particularly for low-income young people, unskilled workers, and the poor.

In the long run, employment prospects could be improved by better labor laws, lower labor costs (due to reduced payroll taxes) and better education quality (a topic outside the scope of this report). However, such changes can take a long time to materialize. In the short and medium term, it is important to facilitate *labor force mobility*, to increase the *employability* of unskilled workers already in the market and of new entrants by helping them to acquire better skills, and to reduce *job search constraints* to improve the match between the available supply of and demand for skills. These goals can be pursued by combining income protection and labor market programs.

To facilitate *labor force mobility*, countries should consider reforming severance pay systems and giving firms more flexibility in their human resources management. Workers need better 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 skills redundant. These goals can be met by unemployment insurance systems that include re-training and job intermediation programs. Such programs can also help to control the inevitable moral hazard implications of being able to receive income while not working. Thus, as in many OECD countries, as a condition for getting income support, benefit claimants would be required actively to seek work or to participate in training to improve their employability.

International experience has shown that well-designed and targeted ALMPs can increase the employability of low-skilled workers and reduce their job search constraints. The main challenge is to identify the factors limiting their employability and constraining their job search effort in a given labor market and then design programs to address those factors. Employability constraints involve *technical* and *non-technical 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 involve *information/access* and *signaling problems* but can also refer to capital constraints for self-employment (human, social, or physical capital). In addition, there can be *transitory* cyclical fluctuations in investment and output and shocks resulting from technological change or demographic transitions that reduce labor demand and justify government interventions. Table 5 summarizes appropriate programs to address each of these market failures.

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

Table 5: Employment Barriers and Potential Corrective Measures

Employability constraints	
Technical skills mismatches	Access to vocational training services
	On-the-job training, internships, and work experience programs
	Develop training sector
Non-technical skills mismatches	Coverage in hard-to-reach areas and population
	Access to general and life skills training services
	Develop school and non-school based programs
Job search constraints	
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: Authors' development.

In conclusion, this section has laid out general principles for ways in which LAC's SP systems could move ahead with the suggested agenda. It proposes expanding participation in contributory social insurance by opening up core programs to all workers and facilitating participation by the low paid – instead of creating special, second class programs for the poor. It has also suggested ways to go about redesigning solidarity subsidies in social insurance systems, to make them more transparent, equitable, progressive and compatible with the expansion of SI systems to cover workers whose incomes are insufficient to fund the whole cost. It then outlined general principles to be borne in mind when reforming programs to make benefit packages uniform and consistent with contributions, to exploit possible synergies by combining some types of social insurance and to ensure that program design is consistent across social insurance, safety net and labor market programs. The following section explores in greater detail the implications for each type of SP program, covering in sequence: pensions, health, unemployment insurance, active labor market and safety net programs.

III. Implications for SP Programs

This section summarizes the most important recommendations that flow from the conceptual framework and the general approach to reform outlined above for the main types of SP programs in LAC.

Pensions

There are several ways to organize a mandatory pension system, depending on how risks are distributed (defined benefit versus defined contribution systems), how the financing mechanism is set up (pay-as-you-go or funded), and the type of institutional organization (centralized versus decentralized or public versus private). Regardless of which choices are made, the vision for the SP system discussed in the previous section has several implications for both contributory and non-contributory systems.

Contributory systems

For countries with defined benefit (DB) systems (Argentina, Brazil, Ecuador, Guatemala, Haiti, Honduras, Nicaragua, Paraguay, and Venezuela), the first challenge is to adjust benefit formulas and

eligibility conditions to remove implicit redistribution, improve incentives, and restore financial sustainability.³⁷

If properly designed, DB-PAYG systems can be viable and sustainable over the long term, even when the population is aging. They can also play an important role in diversifying financial and labor market risks within the pension system, and the recent financial crisis has emphasized this.³⁸ In most cases, however, benefit formulas and eligibility conditions need to be revised so that all individuals receive the same rate of return on their contributions and so that this rate of return is sustainable.³⁹ This can be achieved in two ways. The first is to keep DB formulas but calculate the accrual rate⁴⁰ 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 revalorized by the sustainable rate of return of the system.⁴¹

The second option is to move to a defined contribution (DC) formula, but without changing the financing mechanism. This is the so-called notional defined contribution (NDC) system.⁴² This type of system – which has been successfully introduced 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 are notional, since the contributions are not invested in financial assets) are transformed into an annuity.⁴³ Either of these options would ensure that all individuals would receive the same rate of return on their savings. These arrangements are also likely to increase incentives to enroll and contribute in the SP system since each contribution counts towards the value of the final pension.

For all countries, it is important to continue working on improving incentives to enroll, particularly for small and medium-sized enterprises and the self-employed. This would involve removing any legal constraints that may be preventing the enrollment of these groups. It would also involve interventions to improve the quality of services and to facilitate affiliation and the 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, there is a need to review indexation policies. The goal should be to remove discretion in adjusting the value of pensions to compensate for price increases. The simplest way to do this is through indexation of benefits, so long as the inflation rate remains within a band that would be specified by the monetary authorities. Only when inflation went 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-FF systems, the recent financial crisis has emphasized the need to reduce the exposure of plan members to financial risks. Doing this could involve both the

³⁷ It will also be necessary to review benefit formulas, eligibility conditions, and financing arrangements for survivorship and disability pensions. Similar principles would apply.

³⁸ See Dorfman et al. (2008).

³⁹ 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).

⁴⁰ The accrual rate is the share of pre-retirement earnings that the individual receives for each year of contribution.

⁴¹ For more detailed discussions about how to set benefits formulas and eligibility conditions in earnings related systems with pay-as-you go financing, see Robalino (forthcoming).

⁴² For a description of the systems and for technical analysis regarding their operation, see Holzmann and Palmer (2005).

⁴³ 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.

implementation of default low risk portfolios for individuals close to retirement age and more flexible arrangements for the pay-out phase. These are complex technical issues which go beyond the scope of the present study; a comprehensive review of the options can be found in Impavido and Lasagabater (2009).

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 any individual – 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 the two cases, governments could reduce the transfer only gradually as income increases (i.e., adopting a gradual claw-back of the transfer) to reduce effective marginal tax rates.

Policymakers should also give careful attention to the level of benefits and the eligibility age, to avoid creating negative incentives and to control costs. Benefits set at the equivalent of 15 to 25 percent of economy-wide average earnings would be within the international norm. It is also important to raise the eligibility age to reflect any increases in average life expectancy in order to contain fiscal costs.

Finally, there are several open questions that still need to be answered. 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, there are valid arguments in favor of broadening eligibility to include the elderly, instead of developing special programs for non-contributory pensions. Another issue is whether to use *ex-ante* transfers (matching contributions) to stimulate the long-term savings of low-income workers in order to reduce the long-term costs of social pensions. This type of program should be piloted and evaluated.

Institutional organization

There is also ample room to increase horizontal equity and economic efficiency by ensuring that benefits are more portable and by harmonizing the benefit levels of parallel plans. Portability is intrinsic to DC systems but is also feasible in DB systems so long as the DB formula is well 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 taken in LAC countries, including the effort to facilitate portability in the Caribbean, the harmonization and coordination of civil servant schemes in federal countries like Brazil and Mexico, and the integration of contributory advance funding schemes and the non-contributory programs in Chile. Related to this, countries like Brazil, which have different benefit formulas within the same scheme, will need to consider adopting a single formula that respects the principles outlined above.

Health

In many countries, health system mandates need to be revised to achieve the dual objective of improving health outcomes and protecting people against the financial consequences of ill-health (in both cases, in an equitable manner). National health services (NHSs) and social health insurance systems alike should guarantee the right of access for all residents to a defined set of services. There is also a need to remove any implicit rationing that may be preventing people from benefitting in practice from “rights” that exist on paper. These rights need to be ensured in terms of both the number and quality of services. Eligibility for contributory social health insurance systems should be opened up to all residents. Restricting eligibility to people with formal sector jobs as is done now

hampers labor market mobility.

To achieved these objectives, countries with fragmented health care systems need to: (i) ensure the financial sustainability of the programs; (ii) review redistributive policies to ensure a more equitable use of limited public resources; and (iv) improve institutional arrangements to promote integration/harmonization, minimize the fragmentation of the risk pool; control costs; and improve quality.

Contributory systems

Most of LAC's contributory social health insurance systems are facing major – and growing – challenges to their financial sustainability that are going to require actions to control costs, strengthen revenues, and limit subsidies. As currently constituted, they offer almost unlimited benefits packages and are likely to come under even greater financial pressure from forthcoming demographic, epidemiological and technological changes that will generate growing demand for increasingly complex and costly interventions. Any cost overruns incurred by the region's social insurance systems have to be covered by general tax revenues, in the form of bail-outs. In many LAC countries, this has become institutionalized in the form of permanent and highly regressive subsidies to shore up insolvent health insurance systems, which generally cover only relatively wealthy individuals in the formal sector workforce. To reduce such subsidies and make their financing less regressive, there is a need to strengthen enforcement to ensure that members make their contribution payments. In principle the full cost of the program's benefits should be covered by the contribution pool, and this means that most systems would either need to reduce their benefits packages or increase their contribution rates.

Redistributive arrangements

All households with the ability to pay for at least part of their health insurance should normally be required to contribute to the financing of the system. To move towards this paradigm, the governments of LAC will have to improve the targeting of non-contributory programs for the poor and to encourage affiliation to contributory systems by carefully designing of contribution rates and subsidies. Rigorous targeting of subsidized health care is needed to avoid giving workers a disincentive to enroll in social health insurance programs and an incentive to work in the informal sector. This will entail setting up accurate and up-to-date information systems with databases that can identify those residents who can and cannot afford to pay contributions to prevent any errors of inclusion/exclusion in the subsidized system.

At the same time, policymakers should consider basing workers' contribution levels on something other than their earnings, as this gives them a disincentive to work in the formal sector and contribute to mandatory SI programs. There are three possible options. First, the cost of social health insurance could be subsidized by general tax revenue. Second, contributions could be set as a flat rate and enforced through an online information system that would allow health facility staff to verify patients' affiliation and contribution status when they seek care. Third, contributions could be based on risk-rated premiums that align contributions with benefits and thus encourage affiliation. However, a shift to any of these options would be distributionally regressive, since they would reduce what better-off insured people would pay for health care. Therefore, it would still be necessary for the government to subsidize those whose means were too limited to contribute. However, if these subsidies were used to encourage informal sector workers to enroll and contribute to the system, this would increase the overall revenue-raising capacity of the health systems as a whole.

Adopting these four reforms could make a major difference to ensuring adequate health coverage in LAC. Strengthening the mandate of health systems would give life to the social contracts that enshrined health care as a constitutional right in most LAC countries a century ago, but have never been fully honored. However, achieving this will require increasing public spending on health by using general tax revenue to fund non-contributory programs and subsidies for informal workers to join contributory programs. This will allow out-of-pocket expenditures to be reduced and health financing systems to become more progressive. There is scope for recouping some of these costs by increasing the efficiency of existing health systems, especially social health insurance programs, to avoid bail-outs and to abolish badly targeted subsidies.

Institutional arrangements

LAC's policymakers need to reduce the fragmentation of the region's social health insurance systems, in order to strengthen their risk-pooling and thus increase equity and efficiency.⁴⁴ At present, most LAC countries contain many different contributory schemes, typically associated with different employers in the public and private sectors. Furthermore, individual schemes are operated by financially independent insurers or purchasing agencies that compete with each other for enrollees. Overly fragmented risk pools require higher overall reserves and more complex transactions. Competitive models also increase the risk of cream-skimming⁴⁵ and leave the most risky enrollees for the insurer or purchasing agency of last resort. Reinsurance and regulation have not been effective in mitigating these problems. In the absence of mechanisms that spread risk subsidies across pools, the only way to strengthen risk-pooling is therefore by avoiding fragmentation or by aggregating pools.⁴⁶

At the same time, in both NHS and social health insurance systems, health financing should ideally be separated from service provision and contracting. Also, policymakers should, where possible, set up performance-based mechanisms for paying health facilities, to give them financial incentives to improve the quality and increase the efficiency of their services. This will also pave the way for the cross-purchasing of services between NHS and social health insurance systems, thus accelerating the functional integration of health service delivery systems, reducing overlaps in health service infrastructure, and closing gaps in geographical access to services. Two other policies with the potential to reduce costs are the application of strategic purchasing to the financing of non-personal health services and ensuring the right balance of investment between personal and non-personal health services.⁴⁷

Unemployment benefits

The recent financial crisis has underlined the need to rethink income protection systems and to expand their coverage. Some countries in LAC have implemented systems based on risk-pooling (unemployment insurance or UI) and or savings arrangements (unemployment insurance savings accounts or 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, there is room to improve the design of current systems to improve incentives and

⁴⁴ In the health sector, risk-pooling is an essential element of effective protection. Indeed, even for population groups with similar *ex-ante* actuarial risk patterns, the *ex-post* incidence of health events is far from uniform (that is, event probabilities are generally quite low). At the same time, the costs of a single intervention can far exceed the saving capacity of the vast majority of households.

⁴⁵ That is, risk selection where insurers deliberately try to exclude individuals with high risk profiles to keep their costs down.

⁴⁶ Studies of European health insurance market reforms that promote competition between insurers conclude that here is no evidence that potential gains in efficiency from competition outweigh the costs of fragmentation. Wagstaff, 2007 and Thompson (date)

⁴⁷ Non-personal health services are those that focus on public health issues, such as health promotion and the management of epidemiological risks.

increase redistribution and financial sustainability - particularly for those relying on unemployment insurance. For the second group, it is time to consider introducing new systems, while phasing out severance pay and modernizing regulations on hiring and dismissal procedures. When assessing their options and designing reforms, policymakers could consider the following recommendations, which are detailed in Chapter 5 of the main report.

Unemployment benefits systems should rely less on risk-pooling through unemployment insurance (UI), with implicit redistribution, and rely 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 spells, and, *ceteris paribus*, increase the unemployment rate. This can be an important issue if UI benefits are extended to informal sector workers. In addition, because low-income workers have lower take-up rates and shorter unemployment spells than middle-income and high-income workers, UI systems can also be regressive. Unlike in DB pensions, making UI systems more actuarially fair by linking contributions to the cost of expected benefits is very difficult.

The alternative is to introduce unemployment insurance savings accounts (UISAs). As with pensions, UISAs can be fully funded, or pay-as-you-go (notional). What matters is that the benefits should be directly linked to how much individuals contributed/saved, thus giving them a strong incentive to work. The system would also incorporate explicit targeted subsidies to top up the savings of low-income workers.

Designing the savings component

As in the case of pensions, there are policy choices to be made in terms of 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 (see discussion below).

Regarding the mandate, in addition to the general principles outlined in the previous section, it is *first* important that choices are based on an understanding of the nature of unemployment shocks and their impact on earnings. *Second*, given uncertainties regarding the potential effects of the program on behavior, it is prudent to start with a conservative mandate that can be gradually expanded if necessary. *Third*, countries 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 benefits and/or stop contributing. The limit, for instance, might be a saved amount 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 unemployment spell.

There is also little rationale for allowing unemployment savings (below the maximum capital) to be used to finance investments or to cover other life events. Such flexibility would give workers too large an incentive to leave their jobs and would reduce the level of precautionary savings necessary to manage unemployment risks adequately. If additional arrangements are needed to promote savings or provide access to credit, policymakers should consider specific instruments, not related to the unemployment benefit system, to make that happen.

Finally, as discussed above, the other policy choice is whether to allow individuals to “borrow,” in other words, to continue to receive benefits when the balance in their individual accounts is not enough to cover the targeted replacement rate or the minimum benefit. This is a good policy that adds flexibility to the system and improves risk management.

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 would always be conditional on having a minimum vesting period. This is necessary to control costs and provide incentives to enroll and contribute.⁴⁸ 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, will be. At the same time, vesting periods that are too high will force workers to go through long periods without adequate protection. Vesting periods ranging between six months and one year are reasonable. 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 would need to be.

As in the case of pensions, it is also 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.

There is also an open question about whether to use *ex-ante* or *ex-post* transfers. As discussed above, 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 integrate their training programs, employment services, skills recertification programs, income support or wage subsidies, and programs to support the self-employed. Some of the main design issues for each of these programs are summarized here.

⁴⁸ This vesting period is not necessary in the case of the contributory part of the benefit, which is self-financed.

Training programs

Training programs should include on-the-job training to offer a holistic training process and 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, see below). 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 also might require the use of wage subsidies.⁴⁹

Given limited resources, it is important to target these programs on the most vulnerable population groups. Most *Jóvenes* programs in Latin America organized a massive campaign advertising the training courses in all selected municipalities. 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 if 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: (i) increasing registration by workers and firms; (ii) improving the quality of the services; (iii) extending their regional coverage; (iv) developing minimum performance standards that can be specified nationally but then adjusted to local constraints; and (v) linking them with other ALMPs and to the receipt of benefits (in those countries that offer income protection). These services should also 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, websites can be used to disseminate information on workers' rights, employment regulation, the availability of programs, resources for job-seekers, vacancies, and links to websites publishing vacancies in other countries. It is also 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 vacancies, helping to screen candidates, and providing information on all the subsidies available. There should be one-stop employment centers delivering a variety of services in one location to facilitate access. Finally, the system should promote competition between public and private providers of services in order to improve incentives and 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 an important way to improve matches between demand and supply in the labor market. This 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 improve the transparency and quality of the qualifications process in relation to the labor market and to civil

⁴⁹ 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.

society. A successful NQF would do the following: (i) describe qualifications in terms of a single set of criteria; (ii) rank qualifications according to a single criterion or single hierarchy of levels; (iii) classify qualifications in terms of a comprehensive set of occupational fields; (iv) 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; and (v) define qualifications in terms of notional learning hours.

Wage subsidies

Successful programs can be created if: (i) subsidies are combined with other services such as skills training and counseling (see above) and (ii) 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 on disadvantaged people who would otherwise be unemployed – and thus reduce substitution effects and “dead weight” losses⁵⁰. In general, the programs would prioritize low-income workers and unskilled young people.

Support for the self-employed

There are few programs that provide services to support the self-employed in the region, and more are needed. The key design and implementation features of such programs include: (i) disseminating of information about the programs through large advertising campaigns (this is particularly necessary to reach low-income individuals or those with low skills, who tend to be less well-informed than others); (ii) establishing an independent panel composed of successful entrepreneurs, university professors, and specialists who select business plans that promise to be profitable and feasible; (iii) providing advisory services to help applicants to prepare their business proposals in order not to exclude low-skilled workers; and (iv) providing training and post-business creation services to potential entrepreneurs. Regarding the latter, 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 proposals have been selected, 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 will need to be strengthened in four major areas, mainly related to the further development of the successful CCT model: (i) coordination between CCTs and the supply side in health and education and between CCTs and the social welfare system; (ii) modernizing procedures for enrolling and “graduating” beneficiaries in a timely fashion; (iii) adapting programs to urban settings; and (iv) strengthening the crisis response capacity of the programs. These issues are fleshed out in the following paragraphs.

Supply side coordination

CCT programs need to operate as part of the overall system of social welfare provision. However, ensuring good quality health, nutrition, and education services remains a big challenge in most

⁵⁰ A dead weight loss, in this context, is the part of a wage subsidy program spent on workers who would have been hired anyway.

countries in the region. Many governments have taken actions to improve services in communities targeted by CCTs. Experience suggests that, when sector ministries work closely together, this is fundamental to the success of CCTs and other inter-sectoral social programs (Levy and Rodriguez, 2004). Where CCTs have enjoyed high-level political endorsement, they have helped to increase coordination among ministries and other agencies and to increase health and education investments in the areas where CCTs operate. The clarification of the roles and responsibilities of the programs themselves and those of high-level social sector planning agencies will be a central theme in the future development of these systems.

Enrollment and graduation

CCT programs have become a permanent feature of the LAC social protection architecture. They now need to develop more sophisticated mechanisms for incorporating new beneficiaries and for “graduating” those families who no longer need long-term income support. This will involve establishing open enrollment mechanisms so that families who 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 re-certification exercise. This, in turn, would require the establishment of local offices that can take applications as well as 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 (such as free health insurance and labor market access programs).

At the same time, existing beneficiaries should be periodically re-certified to ensure that they still meet the demographic and poverty tests for continued program participation. Those who no longer qualify should “graduate” from the program to make room for others. Families who leave because they no longer meet the demographic criteria but who 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 Familia* in Brasil, *Oportunidades* in Mexico, and *Familias en Acción* in Colombia.

The urban environment poses important challenges for non-contributory 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 close together in the same communities. This makes it important to complement geographical targeting with instruments that can identify appropriate beneficiary households and exclude the non-poor.

There are also important differences 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 there is less need to stimulate demand. 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 economic advancement of extremely poor urban households is greater 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 is generally achieved in rural areas.

A promising approach for adapting LAC's social protection systems to the urban environment is to focus on extending access to labor market and 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. 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 there is evidence of demand-side constraints to secondary education completion, CCTs could provide cash incentives for low-income students to complete their secondary education.

It would also be useful to define a new role for urban municipal authorities in social protection. In the past, central governments too often simply delegated social protection to local governments, which had little fiscal capacity to respond. In recent years, national SP programs have been developed, while, in most countries, municipalities play only a limited role. One exception is Brazil, where *Bolsa Familia* is municipally administered. However, across the region, municipal capacity (financial and administrative) has been increased by decentralization, and many large cities have developed their own SP programs. There is now a need to clarify the role of local governments in SP systems, using their growing capacity to identify local needs in consultation with local communities and also to co-finance and deliver SP programs, especially where they have significant fiscal resources. This would need to be coordinated with the structures and financing of national SP agencies. A leading example is Chile where municipalities play a central role in the social protection system, in coordination with the national program, *Chile Solidario*, in ensuring that vulnerable populations are given priority access to essential services.

Strengthening crisis response capacity

The global economic crisis of 2008-9 has highlighted the importance of strengthening safety net responses for the poor. The main message from the crisis is that those countries that have well-structured, long-term anti-poverty programs, such as CCTs, can use them as the basis for implementing temporary responses to protect their targeted beneficiaries against shocks. Mexico, El Salvador, Brazil, Chile, Colombia, and Panama have all used their existing program structures as the basis for creating effective – and cost-effective – responses to the crisis over the last year. However, although they have been effective in helping to protect poor households from the food and fuel shocks, CCTs fall short as a response to any broader crisis that also affects the non-poor. Therefore, policymakers need to give more attention to developing social insurance, labor market services, and training.

The capacity of core social assistance systems before a crisis hits is crucial to a country's ability to help the poor in times of crisis. This should include, at 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 all this is in place, benefit levels can be enhanced and the introduction of new programs can be accelerated to offset part of the shock. When such systems are not in place, as was the case in Haiti in 2008, a country's options for responding effectively to a crisis are far more limited, and policymakers are forced to turn to less efficient interventions such as general food subsidies or temporary workfare programs, which are costly and have only a limited impact.

IV. The trajectory of reform

This report has outlined common challenges in SP for the countries of LAC and a proposed a common vision to address them. However, countries face the challenges outlined above from very different starting points. There are great variations 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 social protection 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, based on what they have or have not done so far: (i) *reformers*, which have implemented major initiatives in all social protection programs in recent years; (ii) *partial reformers*, which have introduced important innovations in some areas; and (iii) *non-reformers*, where no major innovations have taken place.

The first group 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, the Dominican Republic, and Uruguay. Some have reformed their pension systems, others their unemployment insurance systems, and others their social assistance programs. Finally, in countries like Haiti, Nicaragua, and Paraguay, no major interventions have taken place in the social protection system (see Figure 22 and Table 6). In this final section, 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 social insurance programs while extending their coverage and to optimize the use of anti-poverty programs in urban areas.

In *pensions*, in countries with funded defined contribution systems, it is necessary to improve the control of administrative charges, the regulation of workers' investment portfolios during their transition into retirement, and the design of the pay-out phase. In the two countries with pay-as-you-go systems, Brazil and Argentina, it is important to adopt benefit formulas that link the value of pensions to contributions and life expectancy at retirement and that avoid implicit redistribution.

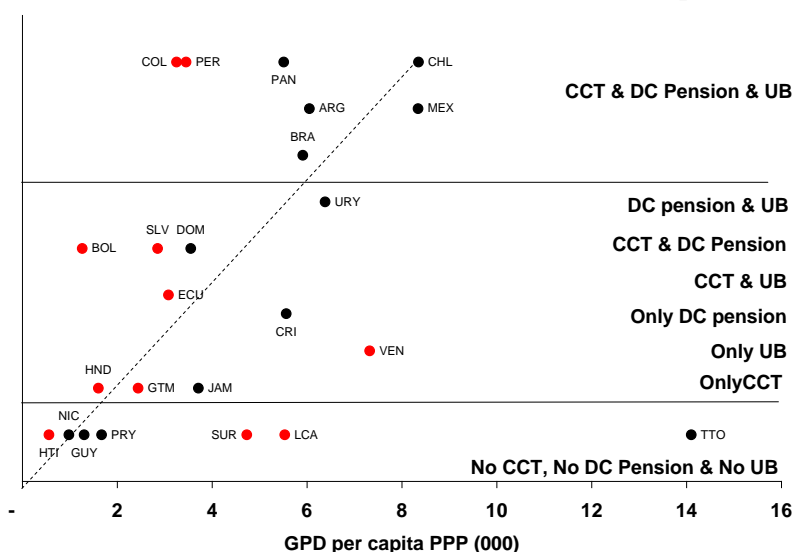
In *health*, the main challenges are to extend good quality basic health insurance to the whole population and to find a way to integrate parallel public social insurance programs and national health services to reduce duplication and costs.

In terms of *unemployment benefits*, there is room to improve the design of UI and/or UISAs, while moving towards more integrated labor market risk management systems. Chile has become a leader in this area, by improving the balance between the savings and redistribution elements of unemployment insurance 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) towards 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, countries need to use redistributive subsidies to leverage the expansion of social insurance. The place to start is to review the non-contributory elements of social insurance, 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 move 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 used in rural areas needs to be adapted to urban social and labor market realities. Subsidized unemployment insurance, coupled with ALMP to link beneficiaries to with sustainable employment opportunities, is a promising complementary approach.

Figure 23: Policy Innovations and Income Per Capita

Source: Authors' development.

Table 6: Initial Conditions that will affect Reforms

Countries	Income level	Poverty and/or income concentration	Government effectiveness and regulatory quality	Aging	Infant Mortality
Group 1: Reformers					
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+
Group 2: Partial Reformers					
Costa Rica, Uruguay, and Venezuela	[5,500 – 7,300]	+ (Costa Rica-; Uruguay-)	+ (Venezuela-)	= (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-)
Group 3: Traditional Systems					
St. Lucia, Surinam, and Trinidad y Tobabgo	[5,500 – 14,100]	+	St Lucia +; Surinam =	=	St Lucia-; Surinam=
Guyana, Haiti, Nicaragua, and Paraguay	[600, 1,700]	+	- (Guayana =)	- (Guyana=)	= (Haiti+)

Source: Authors' development.

Partial Reformers

This is a more heterogeneous group of countries. It includes 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 implicit regressive redistribution from the pension system and then to spend more

resources on preventing poverty and improving the adequacy of health services.

Reforms in *health* are critical. All of these countries (except Jamaica) have fragmented systems, with a low proportion of pre-paid or pooled expenditures (below 50 percent) and there are concerns about the adequacy of the benefits provided by their national health services.

Finally, for *anti-poverty* 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 policymakers in these countries should avoid the temptation of expanding 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 social insurance while expanding their social assistance programs. Costa Rica already has an integrated health insurance system, and the proportion of pre-paid and/or pooled expenditures – close to 80 percent – is among the highest in the region. It has already addressed the main issues that had arisen 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. The main challenge is now the health system, which remains fragmented with low levels of pre-paid/pooled expenditures. There is also room to improve unemployment insurance, building on the infrastructure of individual accounts to implement UISAs linked to the pensions and the health system.

Traditional systems

This 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.

Haiti is a special case, where the immediate focus of policy should be to create effectively administered and well-targeted anti-poverty programs (transfers and income generation programs) and to increase access to good-quality basic services, including health, through the integrated National Health Service. Given fiscal constraints, it is also important to control the public sector wage bill and the cost of civil service pensions.

In Guyana, Nicaragua, and Uruguay, 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. 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 already 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 social protection systems. Their demographic structures are similar to Argentina, Chile, and Uruguay, and their unfunded pay-as-you-go 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 region's lowest. In St. Lucia and Surinam, poverty rates are high, and no

targeted transfer programs have been created. In addition, health systems among this group are fragmented, and pre-paid/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: to tackle the fiscal threat posed by their unreformed pension systems; to meet the income support, labor market, and crisis-response safety net needs of the uninsured poor; and to increase the financing and improve the quality of their health services.

Conclusion

The current socioeconomic environment in LAC countries is conducive to reforms in social protection systems. There is a growing social consensus on the need for a more equitable income distribution. There is also a general recognition that social protection policies can contribute to reversing the trend of income concentration. In addition, the financial crisis has shown that many social protection systems were ill-prepared to deal with economic shocks that affect large parts of the population. Therefore, there is a demand for reform, and basing these reforms on the idea of more transparent and equitable redistribution could bring together 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 very important at the level of principles, while in contrast, at the implementation level, it is essential to adopt a pragmatic and technocratic approach to what works and does not, avoiding “universal models” of how programs should be designed.⁵¹ 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 their SP systems. The specific policies chosen to achieve those objectives will depend on each country’s initial conditions and priorities.

Without doubt, the challenges presented by social protection 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 towards a more coherent, integrated, effective, and equitable SP system in the medium term. The worst mistake would be implement piecemeal reforms that respond only to short-term concerns and minority interests, uninformed by any long-term strategic vision.

The political context in LAC today is marked by a growing consensus on the need to improve income distribution. The review of lessons learned from the successes (and failures) with past reforms in SP, presented in this report, aims to provide policy makers with workable strategies for a new phase of reforms to support that goal. The central idea is very simple. To turn the Right to social protection into a universal Reality, LAC needs to expand access to effective social insurance to the whole workforce. This can be done by opening up contributory plans to informal sector workers and making sure that subsidies to social insurance are transparent, equitable and consistent with incentives to work and save. It also needs to provide a robust and well-targeted safety net for those who remain excluded.

The proposals outlined in this report offer a viable strategy to advance with this agenda, through five key steps. First, governments should explore options to ***open contributory social insurance to all workers***, regardless of where they work and facilitate the inclusion of low income informal sector workers through the adoption of more flexible rules and procedures. Second, they should work to ***reform social insurance subsidy systems***. Where possible, governments should

⁵¹ See Santiso (2006) for a discussion of the importance of pragmatism in the successful reforms in Chile, Brazil, and Mexico.

develop tapered, means tested subsidies to incentivize increased participation by low income workers. It is also recommendable to make such solidarity redistribution transparent and incentive-compatible. This can be done by financing subsidies with general tax revenues, instead of cross-subsidies paid from levies on top of others' insurance contributions and payroll taxes. Third, they should attempt to *improve the coherence of the social insurance systems*, by rationalizing program structures, exploiting opportunities to share savings and insurance pools between risks, and focusing more on interactions between programs. Fourth, they should *deepen safety nets* programs by expanding targeted anti-poverty programs linked to human capital investments, such as CCTs. Finally, they should work to *facilitate access to better jobs* by strengthening active labor market programs to improve the skills and employability of vulnerable groups.

Glossary

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

Active labor market program: 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 and/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 comprises a wide range of unregulated economic and "extra-legal" 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.

Non-contributory 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 where benefits are determined by the accumulation of contributions and notional, legislatively defined 'interest'.

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.

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.

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: Non-contributory transfer programs targeted in some manner to the poor and those vulnerable to poverty and shocks.

Take up rate: The proportion of those entitled to a benefit who actually claim it.

Targeted programs: Initiatives where there is a special effort 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 Saving Accounts (UISAs). Unemployment benefit system where 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: Non-mandatory.

Zero pillar: Non-contributory social assistance financed by the state.

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