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## CHAPTER 6

# Helping Workers Deal with the Risk of Unemployment

**L**ATIN AMERICA'S SHIFT AWAY FROM THE STATE-LED DEVELOPMENT MODEL TOWARD A MARKET-based economic paradigm has rendered obsolete key components of the old income protection system, such as layoff restrictions and the state as employer of last resort. On the one hand, international competition entails the need for firms to use greater flexibility in managing their staffs, weakening the traditional lifetime relationship with their employees. On the other hand, public finance constraints, privatization of public enterprises, and renewed emphasis on financial performance of those remaining in public hands have all led to public sector downsizing and to a much-reduced role of the state as employer. All these developments, together with the potentially adverse employment effects of the economic reform process on some groups of workers documented in Chapter 2, have raised considerable interest in Latin America and the Caribbean in income support programs that could mitigate the effects of economic insecurity in general, and of job loss in particular. This chapter deals with the latter.

As in many other policy areas, developed countries have served as the reference when thinking about the appropriate design of income support programs for the unemployed. Some analysts have discussed ways to adapt unemployment insurance programs to developing countries (Hamermesh 1992), and some have even tried to calibrate the parameters of such programs to the specific characteristics of those countries (Hopenhayn and Nicolini 1999).<sup>1</sup> However, it is not clear that unemployment insurance is the best-suited income

support program under all circumstances. More recently, there have been proposals to introduce individual unemployment savings accounts, whereby workers are forced to set aside money when at work, and are given access to these savings in the event of job loss. While these programs do provide a more certain severance benefit to workers, these proposals are justified largely on theoretical grounds: individual savings accounts provide better incentives than conventional unemployment insurance to contribute to when employed and to search for a job when unemployed.<sup>2</sup> But there are theoretical arguments against this proposal as well. In particular, individual savings accounts do not pool risk among individuals, and thus may be less efficient than those that do so explicitly (such as formal unemployment insurance) or implicitly (such as income support programs financed from general tax revenues).

This chapter assesses a set of income support programs that have been tried in the Latin American context. Rather than starting from a theoretically "ideal" program and adjusting it to the characteristics of a specific country, the chapter considers specific programs that are currently in operation. Until recently, the accumulated knowledge on income support programs for the unemployed in developing countries was quite limited.<sup>3</sup> Hence, while this chapter draws from existing literature, it is mainly based on studies commissioned by the World Bank specially for this report. These studies deal with the operation and effects of specific income support programs for the unemployed in Argentina (Ravallion 2000), Brazil (Cunningham 2000), Colombia (Kugler 2000), Mexico (Wodon 2000), and Peru (MacIsaac and Rama 2000).<sup>4</sup>

The objective is not to generate an unambiguous "ranking" of these programs; all of them can be expected to have

both strengths and weaknesses under different objectives of policymakers, depending on the constraints they face. For example, a program may do well at offsetting the losses formal sector workers experience as a result of increased import competition or deregulation, but fail to reach informal sector workers who risk poverty as a result of aggregate fluctuations. Similarly, a program may have broad coverage, but also entail a large cost for the budget. Which program is best suited for a country depends especially on the state of labor markets (for example, the extent of informal employment and the frequency of joblessness) and the administrative capacity of governments to implement different public income support programs.

This said, it should also be kept in mind that governments can overcome some of these constraints over time: labor market reforms can reduce the difference between formal and informal activities, and administrative capacity can be built. In going from what governments have done to facilitate income support to the unemployed to how they could do better, therefore, we bring in a medium- and longer-term perspective as well. While some of the policy recommendations are based on specific theoretical premises, we believe that a blend of practicality and analytical rigor can help countries devise strategies that efficiently bridge immediate action and long-term vision. This chapter introduces programs of income support in five countries, distinguishing their key features; summarizes the evaluation of these programs; and using the main findings of these and other studies and the comprehensive insurance framework outlined in Chapter 3 as an organizing device, discusses the main policy implications for LAC economies.

## A Typology of Programs

At least five different types of income support programs for the unemployed have been tried in LAC.<sup>5</sup> All of them involve a net transfer of resources to workers who lose their jobs, but the amount, conditions, and sources of the transfer differ substantially across programs. Conceptually, some of these programs can be seen as a mere redistribution of resources, from taxpayers to the unemployed; others amount to forced savings or self-insurance, made available in the event of job loss. Still others resemble market insurance, with a premium being paid while at work and a claim being made in the event of unemployment.

The five types of income support programs used in the region are public works (PW), mandatory severance pay (SP),

training for the unemployed (TG), unemployment insurance (UI) and individual savings accounts (IA). The main features of these programs are summarized in Box 6.1. The timing and nature of the payments involved in each of these five income support programs is summarized in Table 6.1.

To interpret Table 6.1, consider the following stylized labor market sequence. In period 0 the worker loses work, in period F he or she finds a new job, D is the maximum duration of benefits allowed by the income support program, and R is the worker's retirement age. The table is constructed under the assumption that F comes before D, but this is not necessarily so in practice. The rows in the table correspond to the five broad types of income support programs currently in operation in LAC. A zero indicates that the program does not entail any payment, from or to the worker, in the corresponding period. Possible payments include the salary received from a public works program (W), the training allowance (A), the amount of severance pay received from the employer (S), the contribution by worker and employer to an income-support program (-C), a benefit whose amount depends on past contributions (+C), and an old-age pension (P).

In the individual accounts program, the old-age pension can be accrued by the portion of the forced savings that was not used as income support in periods of unemployment. While only workers enrolled with social security can participate in the unemployment insurance and individual accounts programs, the other three programs are in principle accessible to nonenrolled workers—hence the question marks in the postretirement columns of Table 6.1. Other question marks in this table reflect the possible inability or unwillingness of the social security administration to monitor whether beneficiaries are actually out of a job.

In this report, we take one example of each of the five programs and examine how well it has helped to deal with job loss. Public works are represented here by Argentina's *Trabajar* program. This program was created during 1996–97, in response to a surge in unemployment in 1995. *Trabajar* allocates funds across provinces based on the distribution of the unemployed poor. Proposals to use the funds are made by municipalities and non-government organizations. These proposals are approved at the regional level, based on a system of points related to poverty in the area and the merits of the project. The government pays for the costs of unskilled labor and the sponsoring units pay for materials and skilled labor. The wage of unskilled

## BOX 6.1

**Income Support Programs for the Unemployed: Main Features**

**Public works.** This income support program was used by Chile in the 1970s and 1980s, and was introduced more recently by Argentina, Brazil, Colombia, and Mexico. The program provides low-wage jobs to all those who are willing to take them. In principle most of the jobs are in activities that do not compete with the private sector, and the jobs can be physically demanding and typically last for only a few months. Therefore, it is likely that the program attracts unemployed workers and those out of the labor force, and not the currently employed. High effort, short duration, and low pay imply that only the neediest participate.

**Training.** To the extent that some training programs are specifically targeted to the unemployed, and provide an income allowance to the trainees, they can be viewed as a form of income support. Mexico has a large program along these lines. Training programs for the unemployed have some similarities to public works programs: resources are provided by the government, beneficiaries do not need to be enrolled with any social security program to have access to the training, and being enrolled in a training program is usually incompatible with having a job, so that there is some self-selection of the beneficiaries. In addition, these programs generate a “product” in the form of better skills, although the market value of these skills is open to debate. They are different from public works programs in that eligibility rules generally apply—only individuals of specified age or education levels are allowed to participate.

**Severance pay.** This program can be found in most Latin American countries, where the labor code mandates employers to pay an end-of-service gratuity to the workers they fire without a “justified” cause (that is, for nondisciplinary reasons). The gratuity is a multiple of the worker’s salary; in some countries, the gratuity cannot exceed a specified amount or multiple of the worker’s

salary, and in other countries the gratuity formula is different when job separation is due to economic reasons. Employers are usually not mandated to set aside any resources to pay the end-of-service gratuity.

**Individual accounts.** This is a “funded” version of the severance pay program. Workers have individual accounts to which some percentage of their salary is transferred on a regular basis. In the event of job separation, whether voluntary or involuntary, workers can draw resources from their accounts. Any resources left in these accounts at retirement can be used toward old-age pensions. Workers can also “borrow” from their accounts under specific circumstances. A program along these lines has existed in Brazil for more than three decades. More recently, Colombia has replaced its severance pay program with fully funded individual accounts of this type. Unlike unemployment insurance and severance pay, this program involves no net transfer of resources to workers who lose their jobs.

**Unemployment insurance.** This program, modeled after those in developed countries, can be found in Argentina, Barbados, Brazil, Ecuador, Uruguay, and Venezuela. Workers and employers in the formal sector make regular contributions to a fund, generally managed by the country’s social security administration. After a specified contribution period, workers are entitled to an unemployment benefit in the event of job loss (but not of voluntary separation). The benefit is some percentage of the workers’ salary, typically declining over time. Benefits are paid for as long as the worker remains unemployed, up to a maximum of several months or years. However, monitoring whether beneficiaries take a job in the informal sector is practically impossible, so some of the programs do not even attempt to make the payment of benefits conditional on actually being unemployed.

laborers is set at two-thirds of the average wage for the poorest decile in the capital city. In principle, there are no restrictions on the eligibility to participate in the program, but in practice there is rationing.

Mexico’s *Probecat* training program was created in 1984, in response to rising unemployment and deteriorating liv-

ing standards due to the 1982 economic crisis. The stated objective of the program is to improve the productivity of unemployed workers to help them find jobs. The program provides publicly funded training and a subsistence allowance during the training, with a maximum duration of six months. The allowance is equal to the minimum

TABLE 6.1

**How Various Income Support Programs for the Unemployed Work**

PERIOD	EMPLOYED	LOSES JOB	UNEMPLOYED	FINDS ANOTHER JOB	INCOME SUPPORT ENDS	UNEMPLOYED	AT RETIREMENT
	-1	0	1	F	D	D+1	R
Public works	0	0	W	0	0	0	?
Training for unemployed	0	0	A	0	0	0	?
Mandatory severance pay	0	S	0	0	0	0	?
Individual saving accounts	-C	+C	+C	0	0	0	P+C
Unemployment insurance	-C	?	B	B?	B?	0	P

*Note:* The timing of events is as follows: in period 0 the worker loses his or her job; in period F he or she takes a new job; D is the maximum duration of benefits; R is the retirement age. The table is constructed under the assumption that F comes before D, but this is not necessarily so in practice. The programs involve the following payments or transfers: W is the salary paid by the public works program; S is the amount of severance pay received by the worker; A is a training allowance; -C is the contribution by worker and employer to a program; +C is a contribution-defined income transfer; P is the old-age pension, with the question mark indicating that beneficiaries of the program are not necessarily enrolled with social security; B is unemployment benefits, with the question mark indicating that the worker may not receive the benefit during that period.

wage plus transportation costs and health insurance coverage. Training was initially carried out in schools and training centers, but it was subsequently expanded to enterprises as well. Participating enterprises are required to hire at least 70 percent of the trainees. Beneficiaries are selected based on a system of points, and can get trained only once. For about a decade the program was small, but after several positive reviews the program was expanded by a factor of 10. Two criteria are used to evaluate the program: success in providing income support (that is, an income transfer or “social insurance” function) and effectiveness in reducing future incidence or duration of unemployment (that is, aiding “self-protection”).

The mandatory severance pay program examined here is the one Peru had during the 1990s. Over the two previous decades, this program had been part of an attempt to guarantee job security to workers after probation. Job security regulations lost their teeth in the early 1990s and were formally abolished in 1993. But mandatory severance pay regulations were not substantially eased. Although the formula setting the amount to be paid in the event of “unjustified” dismissal was modified four times in the 1990s, the basic structure remained the same. As of 1996, the employer had to pay one month of salary per year of service, up to a maximum of 12 months. In 1997, mandatory severance pay was raised by 50 percent. Since then, the mandatory severance pay program of Peru has not been modified.

Colombia is one of the few LAC countries that succeeded in replacing its mandatory severance pay program with an individual accounts program. This change was made in 1990, at a time when the unemployment rate was

low. It was part of a broader set of reforms, which included trade and financial liberalization. Under the new system, workers have to contribute 9.3 percent of their salary to an unemployment fund. They are entitled to their savings in the event of termination, but can also “borrow” from them for housing and education purposes while employed. In the old system, workers could also borrow part of their severance pay entitlement from their employers, but the value of the loan was not appropriately adjusted for inflation. Some specific groups of workers can opt out of the new system, and get a higher salary in exchange for not being covered by the program.

Brazil has the largest unemployment insurance program in the region, though it is small in comparison with those in OECD countries with relatively frugal UI systems, such as the U.S. system (see Table 6.2 and Gill, Dar, and Thomas, 1999). This program was created in 1986, as part of a policy package (the *Cruzado* plan) aimed at price stabilization. The program is funded by taxes levied by employers. To be entitled to unemployment insurance benefits, a worker has to be covered during 15 of the 24 months preceding job loss. Benefits are in the range of one to two minimum monthly salaries,<sup>6</sup> depending on past contributions. Benefits are paid in monthly installments, up to a maximum of 120 days, but they are not contingent on being out of work. Workers need to be present in person at social security centers to collect their benefits.

## Main Findings

The five income support programs can be assessed along several dimensions (see Box 6.2). Proposals to introduce

TABLE 6.2

**Contrasting the Brazilian and the U.S. Unemployment Insurance Systems**

CHARACTERISTICS	BRAZIL	U.S.
Administered by	Federal government	State and federal governments
Number of Claimants	3–5 million per year	15–20 million per year
Objectives	(i) Alleviate hardships due to loss of earnings (ii) Automatic macro stabilization (iii) Improving quality of job matches (iv) Making employers share burden of unemployment	(i) Alleviate hardships due to loss of earnings (ii) Automatic macro stabilization (iii) Help stabilize employment by experience-rating of employers
Tax Rate	Federal tax = 0.65% of revenues of private firms, 1.0% of revenues of public firms, and 1.0% of expenditures of nonprofit firms	Federal tax = 0.8% of taxable payroll; State Tax varies from 0–10% of taxable payroll according to employers' experience-rating
Tax Base	Firm revenues or expenditures (see box above)	Federal: up to \$7,000 of each employee's payroll States: at least \$7,000 of each employee's payroll (80% of states had tax base above \$7,000)
Use of Funds	40% of collections transferred to uses other than paying UI benefits through mandated transfer to national development bank	Both principal and interest must be used to pay only UI claims
Benefit Replacement Rates	80% of reference wages up to R\$220 per month; 50% of wages between R\$220–254 per month; 0% above this	Between 32–57% up to benefit ceiling. Lowest ceiling is \$180/week; highest is \$390 (\$575 with dependency allowance)
Reference Wage	Average salary 3 months prior to dismissal	Last salary before dismissal
Duration of Benefits	3–5 payments depending on work history during previous 3 years; can receive UI payment package only once in 16 months	Regular benefits up to 26 weeks; extended benefits up to 13 additional weeks; additional temporary benefits during recessions

Source: Gill, Dar, and Thomas (1999).

“optimal” unemployment insurance, or individual savings accounts, usually focus on the incentives these programs could provide for workers to actively search for jobs. In countries with high informality, however, it is also important to consider who these programs reach. In addition, the burden of some of these programs does not fall only on their beneficiaries. Depending on who “pays” for the benefits, and how, the programs can have different implications on efficiency and equity grounds. Finally, in the absence of income support programs, some of the unemployed could resort to their savings, or to transfers from relatives, to support their consumption. It is therefore important to assess whether formal income support programs really help smooth consumption, or simply replace other more informal self-insurance mechanisms. Based on these considerations, the findings on these five income support programs can be summarized along four dimensions:

- **Coverage.** How many workers are eligible to participate in the income support program considered? How many actually benefit from an income transfer, or have benefited from one recently? How does coverage vary with wealth?

- **Cost.** How large are income transfers in the program considered? What fraction of the total cost of the program is actually received by the worker? Do workers “buy” income protection through lower wages, or is the burden shifted to employers or taxpayers?
- **Incentives.** Do workers who are covered by the program remain unemployed for longer periods than those who are not? Do they find jobs with higher earnings, or jobs that are “better” in any other sense?
- **Insurance.** Do workers who are covered by income support programs display smoother consumption patterns than those who do not? Does the consumption of covered workers fall less, other things equal, in the event of job loss?

Not all these questions can be easily answered for all the programs. This would require a vast amount of information on the employment, earnings, and consumption history of a representative sample of workers, and the data available in the five countries usually do not deal with all of these variables at once. Moreover, information on the individual characteristics of the workers (such as age and education) is necessarily limited. Therefore, it is always

## BOX 6.2

**Data Sources and Methodology***Argentina's Trabajar*

The effects of the *Trabajar* program are assessed combining two household surveys. One of them, the *Encuesta de Desarrollo Social* (EDS), was carried out in 1997 and covered the population residing in localities with 5,000 or more inhabitants. Jalan and Ravallion (1999) constructed a comparison group out of the EDS sample, using matching methods. The other household survey used to assess the effects of *Trabajar* is a 1997 sample of its participants, covering 3,500 households. The information used by Ravallion (2000) on *Trabajar* is from government records.

*Mexico's Probecat*

The assessment of the *Probecat* program by Wodon and Minowa (1999) combines data from the 1993–94 rounds of National Urban Employment Survey (ENEU) and from a survey administered roughly at the same time to *Probecat* trainees. The latter was designed to match the questions in the ENEU, so that information from the two surveys is comparable. The two samples are combined by Wodon and Minowa (1999) using matching methods.

*Peru's Mandatory Severance*

The study on the effects of mandatory severance pay in Peru by MacIsaac and Rama (2000) uses panel data from the Living Standards Measurement Surveys (LSMS) of 1994 and 1997. The panel nature of the data allows control for unobservable differences across individuals. MacIsaac and Rama combine several job indicators (years of service, written contract, enrollment with social security, size of the establishment, and presence of a union) to evaluate whether a worker will get severance pay in the event of unjustified dismissal. The survey also contains information on earnings at the individual level, and consumption at the household level. Saavedra and Torero (1999) analyze the impact of mandatory severance pay on turnover using data on job tenure from the *Encuesta*

*Annual de Hogares*, for all the years between 1986 and 1997. They attribute all the observed changes in job tenure to the weakening of job security regulations, although this was not the only reform or shock that took place over this period.

*Colombia's Individual Savings Accounts*

In the case of Colombia, a similar natural experiment is provided by the 1990 labor market reform, which replaced severance payments by individual accounts. The data used by Kugler (2000) to assess the effects of this change are drawn from the June 1998, 1992, and 1996 rounds of the *Encuesta Nacional de Hogares* (ENH). This survey was administered in the seven largest metropolitan areas of Colombia. June waves of the ENH include special modules on informality, thus allowing the identification of workers who are covered by mandatory severance pay regulations (until 1990) or included in the individual accounts program (afterward). Given the nature of the policy change in 1990, the results obtained refer to the effects of replacing severance pay with individual accounts, not to the specific effects of the latter.

*Brazil's Unemployment Insurance*

Brazil's unemployment insurance program is studied by Cunningham (2000) using data from a sample of males and females of working age who left a nonagricultural job, spent at least one month unemployed, and found a new job. This sample is drawn from the *Pesquisa Nacional de Amostra de Domicilios* (PNAD) in all years from 1992 to 1997, except 1994, when there was no survey. Each round of the PNAD survey has over 360,000 observations. Despite being quite restrictive, the criteria used by Cunningham led to a pooled sample of more than 24,000 individuals. The increase in the generosity of unemployment insurance benefits that took place in 1994 serves as a natural experiment, allowing a difference-in-differences evaluation of the effects of participation in the program.

possible to argue that differences in employment, earnings, or consumption are not due to participation in a specific income support program, but rather to unobservable char-

acteristics of the workers (for example, talent) which are correlated with program participation. For these reasons the evaluations should not be considered definitive assess-

ments. But the studies commissioned for this report, and some other recent papers, take advantage of multiple observations for the same workers, or of changes in the regulatory framework, to identify some of the effects of the programs.

### *Who Is Covered by these Programs?*

All five income support programs cover, in principle, a considerable portion of the labor force. The highest coverage corresponds to Argentina's public works program, because anyone willing to take a job at the prevailing wage rate is supposedly allowed to do it. In practice, however, the coverage of the program is determined by the resources available. Coverage is slightly lower for Mexico's training program, because eligibility rules apply. The first column in Table 6.3 shows that the other three programs reach a smaller but still sizable share of the labor force. The share appears to be much lower in the case of Peru's mandatory severance pay program, but this is due mainly to the way the denominator is defined: while coverage rates for Brazil and Colombia refer only to workers in the largest urban centers, the coverage rate for Peru refers to all private sector workers, including those in agriculture. The relatively high coverage of the programs is consistent with casual evidence that workers do not opt out of them when given the choice. In Colombia, for example, as of 1995 only 1.5 percent of workers in manufacturing and 0.6 percent of workers in commerce preferred a higher salary in exchange for

not being covered by the individual accounts program (Kugler 2000).

The relatively high coverage of the programs among those at work is in sharp contrast with the relatively low number of beneficiaries among the unemployed, as shown by the second column in Table 6.3. The interpretation of the figures in this column is not straightforward because they compare a flow (the number of beneficiaries in a year) with a stock (the average number of unemployed during the same year). In countries where movements in and out of unemployment are frequent, as in Mexico, the total number of people who are unemployed at any point over the year could be several times higher than the average number of unemployed. Taking this into account, it would be safe to conclude that at best, no more than 1 out of every 10 unemployed workers benefits from the income support programs considered.

There are several reasons for the discrepancy between relatively high legal coverage and relatively low actual coverage. One of them is self-selection. Public works programs pay low wages, offer little continuity, and require hard work, so that only the neediest among the unemployed apply. Because training programs are not as physically demanding, and have the potential to increase skills, they could attract a larger number of candidates. The other three programs could lead to self-selection by employers. The latter should have no interest in extending contracts beyond the probationary period, hence incurring addi-

TABLE 6.3

### **Income Support Programs for the Unemployed: Beneficiaries Across Population Groups**

PROGRAM AND COUNTRY	WORKERS LEGALLY COVERED BY THE PROGRAM	ACTUAL BENEFICIARIES AS PERCENT OF UNEMPLOYED	SHARE OF BENEFICIARIES IN POPULATION GROUP (%)				
			Poorest	2nd poorest	Middle	2nd richest	Richest
Public works in Argentina	In principle, all	7.5	78.6	15.3	3.5	2.1	0.4
Training in Mexico	Eligible by age, education	29.4	69.9	15.5	8.1	5.0	1.5
Severance pay in Peru	21.2% of all private sector	3.6	4.7	9.5	28.6	33.3	23.8
Unemployment insurance in Brazil	39.6% of urban workers	11.8	10.6	24.6	19.1	25.1	13.6
Individual accounts in Colombia	47.2% of urban workers	Unknown	0.0	4.3	Not applicable	19.1	76.6

*Note:* Coverage is based on legal entitlement. The unemployed include first-time job seekers. Data for Argentina are from Jalan and Ravallion (1999) and Jones and Ravallion (1999) and refer to 1997; groups are population quintiles according to household earnings per capita, excluding benefits paid by the program. Data for Mexico are from Wodon and Minowa (1999). Data for Peru are from MacIsaac and Rama (2000) and refer to 1994; private sector workers include farmers, the self-employed, and unpaid family workers; groups are sample quintiles according to household consumption per capita. Data for Brazil are from Cunningham (2000); coverage figures are for 1997; groups are defined based on earnings in last job, as of 1992, with cutoff points at 1, 2, 3, and 5 minimum wages. Data for Colombia are from Kugler (2000), and refer to 1992–96; groups are workers quartiles according to income in last job.

tional costs in terms of contributions or severance payments for workers they may not want to retain.

Another potential explanation for the discrepancy between legal and actual coverage is the weakness of enforcement capabilities. In the case of Peru, MacIsaac and Rama (2000) construct a coverage score that combines four criteria, in addition to legal entitlement: having a written contract, being enrolled in social security, working in a firm where at least one trade union operates, and working in a large firm. It can be assumed that the likelihood of actually getting severance pay in the event of dismissal increases with the number of criteria met by the worker. If only those workers who meet at least one of these criteria do get severance in practice, the coverage rate falls from 21.1 percent to 9.3 percent of the labor force. It drops to 5.2 percent if workers have to meet any two of the criteria. In the case of Brazil, Cunningham (2000) reports that a significant portion of the unemployed is entitled to unemployment benefits, but does not collect them. This could be due to the lack of social security offices nearby.

The actual beneficiaries of income support programs tend to be relatively wealthy, with Mexico's *Probecat* and Argentina's public works program the exception. *Trabajar* is a poverty alleviation program targeted through unemployment, rather than an income support program for the unemployed. In all of the other programs for which the information is available, the poorest population group has the smallest number of beneficiaries. Beneficiaries tend to be more numerous among middle- or upper-middle income groups. Colombia's individual account program is the least pro-poor; more than three quarters of the beneficiaries can be found among the richest quarter of the urban population.

#### *How Much Do the Programs Cost?*

The average income transfer received by the beneficiaries of these programs ranges from roughly US\$300 in Mexico to US\$1,300 in Argentina. The spending figures reported for these two countries in the first column of Table 6.4 are higher, because they also include other costs of the programs. In the case of Argentina, only one-third of each dollar spent is paid to laborers, with the other two-thirds going to materials and skilled personnel in charge of the activities supported by the program (Ravallion 1999a). The ratio increases to roughly three-quarters in the case of Mexico, with the other quarter going to trainers' salaries and other related expenses. The other three income support

programs reviewed in this paper have a higher ratio of benefit to nonbenefit expenses.

Income transfers are financed in two different ways. In the case of Argentina's public works program and Mexico's training program, the funding comes mainly from the budget, hence from general taxation. In the other three cases, the transfers are funded by explicit or implicit taxes on employment. In principle, taxes on employment could be either more or less distortionary than general taxation, depending on the nature of the tax system in force. But all taxes carry a marginal burden, in the sense that they reduce economic efficiency. This burden should be factored in when assessing programs such as Argentina's *Trabajar* or Mexico's *Probecat*. More specifically, the value of the physical or human assets generated by the programs should not be high enough just to cover their cost, but also to cover the corresponding marginal tax burden. The last column in Table 6.4 suggests that in practice this is not the case.

The employment tax is formally similar in the Brazilian, Colombian, and Peruvian income support programs. In particular, contributing 9.3 percent of the workers' salary to an individual accounts program amounts to setting aside roughly one month of salary per year of work. Therefore, in the mid-1990s the employment "taxes" in the Colombian and Peruvian income support programs were roughly the same. Some of the proponents of the individual accounts system claim that an income support program along the Colombian lines is less burdensome to employers than a program along the Peruvian lines. However, Peruvian employers could set resources aside on a monthly basis, if they wished to. It is not at all obvious that forcing them to do so would make them better off. However, savings accounts that are administered by third parties (not employers or workers) do facilitate labor mobility, reduce legal claims, and provide workers with more certain benefits.

A potentially more important difference between income support programs relying on an employment tax is related to the endogenous adjustment of wages. If a program is valued by the workers, they should be willing to "pay" for it through lower wages. In principle, the net impact of a program on wages depends on its explicit or implicit employment tax, on how much the workers "value" the benefits from the program, and on the wage elasticity of labor demand and supply. This net impact was evaluated using panel data estimates for Peru by MacIsaac



TABLE 6.4

**Income Support Programs for the Unemployed: Cost per Beneficiary**

BURDEN ON EMPLOYERS					
PROGRAM AND COUNTRY	AVERAGE SPENDING PER BENEFICIARY (IN U.S. DOLLARS)	CONTRIBUTIONS OR PAYMENTS	CHANGE IN EQUILIBRIUM WAGE (IN %)	BURDEN ON TAXPAYERS	VALUE OF ASSETS GENERATED PER BENEFICIARY
Public works in Argentina	3,100	None	Not applicable	All	Similar to spending
Training in Mexico	393	None	Not applicable	All	Insignificant
Severance pay in Peru	760	1 monthly wage per year, lump sum	Insignificant	None	Not applicable
Unemployment insurance in Brazil	664	0.65% of firm's revenue, monthly	Unknown	None (the system runs a surplus)	Not applicable
Individual accounts in Colombia	Unknown	9.3% of workers' wage, monthly	Insignificant	None	Not applicable

*Note:* Data for Argentina are from Ravallion (1999a), Jalan and Ravallion (1999), and Jones and Ravallion (1999), and refer to 1997. Cost data for Mexico were kindly provided by Quentin Wodon; the assessment of the value of the assets is from Wodon and Minowa (1999). Data for Peru are from Maclsaac and Rama (2000); payment by employer refers to 1994, whereas change in equilibrium wage was estimated on 1994–97 panel data. Data for Brazil are from Cunningham (2000); spending refers to 1995. Data for Colombia are from Kugler (2000); the change in the equilibrium wage was estimated using differences in differences for 1990 and 1992–96.

and Rama (2000), and using difference-in-differences estimators for Colombia by Kugler (2000). In both cases, the net impact turned out to be statistically insignificant, implying that the burden of these two programs falls entirely on employers.

***What Are the Efficiency Effects and Insurance Benefits?***

Proposals to introduce “optimal” unemployment insurance or individual savings accounts often emphasize the distortions to incentives created by conventional unemployment insurance. Key among those distortions is the lower effort devoted to a job search by those who collect unemployment benefits. On the other hand, it can be argued that income support allows the unemployed to search for a longer period, possibly leading to a better job match. More generally, income support programs for the unemployed could have effects on the duration of unemployment spells, on the earnings level subsequent to reemployment, and even on nonpecuniary characteristics of the new jobs. The evidence available in this respect is limited. However, the results summarized in Table 6.5 suggest that all these incentive effects are weak.

Some of the evidence on unemployment spells is difficult to interpret. In the case of Peru, the allegedly longer unemployment spells are derived from an analysis of changes in job tenure over time. Saavedra and Torero (1999) show that job tenure was longer in the 1980s, when job security regulations were in force, than in the 1990s,

when they were substantially weakened. But there was mandatory severance pay in both periods, whereas in the meantime the economy was subject to many other economic reforms and external shocks. In the case of Colombia, the shorter unemployment spells reported by Kugler (2000) after 1990 could not be due to a change in the amount of the transfers received, or in the conditions attached to them. The only difference is that in the new system the beneficiaries can keep the unused portion of their transfer in their individual accounts, whereas in the old system they would have had to put that portion into a bank account, or found some other form of investment for it. It is difficult to believe that the difference in returns between these two alternatives is large enough to justify a difference of three weeks in the duration of unemployment spells. The same reasoning casts doubt on the allegedly higher earnings observed upon reemployment.

One of the few clear-cut results in Table 6.5 refers to where people get jobs after unemployment ends. In the case of Brazil, Cunningham (2000) finds that unemployment beneficiaries are more likely to become self-employed than nonbeneficiaries. This result is consistent with credit rationing at the household level. Under this hypothesis, unemployment benefits would provide start-up capital, and the most profitable use of this capital would be to run an independent business. This choice would not be available to those who do not receive unemployment benefits. This result is also consistent with the view that working in

TABLE 6.5

**Income Support Programs for the Unemployed: Effects on Employment, Earnings, and Consumption**

	EFFECTS ON DURATION OF UNEMPLOYMENT	EFFECTS ON EARNINGS ON REEMPLOYMENT	EFFECTS ON SECTOR OF REEMPLOYMENT	CONSUMPTION/INCOME RELATIVE TO NONPARTICIPANTS
Public works in Argentina	Unknown	Unknown	Unknown	25.9% higher income
Training in Mexico	Insignificant	Insignificant	Unknown	Unknown
Severance pay in Peru	Longer	Unknown	Unknown	Consumption rose 6.8% for beneficiaries; fell 16.9% for nonbeneficiaries
Unemployment insurance in Brazil	Insignificant	Insignificant	Self-employment more likely	Unknown
Individual accounts in Colombia	Three weeks shorter	5.5% higher	Unknown	Unknown

*Note:* Information for Argentina is from Jalan and Ravallion (1999), based on 1997 data on household income per capita. Information on Mexico is from Wodon and Minowa (1999). Information on Peru is from MacIsaac and Rama (2000) for consumption, using data for 1994–97, and Saavedra and Torero (1999) for other; unemployment spells are assumed to be longer because the average job tenure was longer in the late 1980s, when job security regulations were in force, than in the late 1990s. Information on Brazil is from Cunningham (2000). Information on Colombia is from Kugler (2000); unemployment spells are shorter compared to those of workers entitled to severance pay, but not necessarily compared to those who are not covered by an income support program.

the informal sector is not necessarily an inferior outcome, but often a deliberate choice.

Credit constraints at the household level could also underlie the apparent effectiveness of income support programs at providing insurance, which is suggested by the evidence from Argentina and Peru. If households could borrow when one of their members is confronted with temporary job loss, they should not experience a serious drop in consumption. In Peru, consumption per capita drops by more than 16 percent when one household member becomes unemployed *and* does not get severance; on the other hand, consumption per capita increases by almost 7 percent if the unemployed member gets severance. This result suggests that the Peruvian program mandates severance payments that are too generous. Jalan and Ravallion (1999) show that the foregone income from participating in Argentina's *Trabajar* program amounts to only half of the transfer received.<sup>7</sup> For the average household, participation results in an increase of almost 26 percent in income per capita, a figure quite close to the 23 percent difference in consumption per capita between beneficiaries and nonbeneficiaries in Peru. Unfortunately, there are no similar estimates available for the other three income support programs considered.

***What Are the Main Weaknesses of these Programs?***

Before drawing the policy implications of these assessments in the broader context of macroeconomic and labor

market changes in the region, we offer some summary observations specifically for the five programs surveyed above. First, nonlabor costs in Argentina's *Trabajar* appear to be high, so there is room for improving the effectiveness of public works programs as instruments for income transfers by lowering the non wage component, though this may jeopardize the quality and nature of the investments being made through the program (see also the following section). Second, the training in Mexico's *Probecat* seems ineffective, so there may be potential saving if the share spent on training costs is reduced or redirected. Third, severance pay in Peru appears to be excessively generous. Fourth, individual savings accounts in Colombia seem to be used mainly by the wealthy, who are more likely to have voluntary savings anyway. Fifth, Brazil's unemployment insurance scheme covers largely those who also have individual severance accounts, thus providing insurance—although quite frugal for most workers—to those who also benefit from mandatory severance laws. Finally, these programs cover little more than 10 percent of the unemployed, implying that by themselves they fail to offer most workers any insurance against job loss.

**Policy Implications**

There is an increasing clamor for greater unemployment insurance in the region. There is also a widely held view, however, that given the nature of labor markets and the extent of administrative capacity in developing countries,

they should hesitate before setting up formal unemployment insurance systems. In fact, extensive informality results in even greater problems in administering benefit payments because it is difficult for the UI agency to determine if claimants are in fact unemployed: many may be working in the unregulated sector while drawing benefits. It also creates problems in financing the UI system because it will be impossible to make a large number of employers and employees pay their contributions. The recent experience of Argentina is symptomatic of both problems (see for example, Mazza 1999). These considerations have led observers to argue that middle-income countries in East Asia and Latin America would be better off reforming their mandated severance payment schemes rather than instituting formal UI systems (see, for example, Edwards and Manning 1999). Variants of Brazil's individualized severance accounts (*Fundo Garantia por Tempo de Serviço* [FGTS]) are sometimes recommended as a substitute for unemployment insurance.

Using the findings summarized in the last section and the conceptual framework outlined in Chapter 3, this section reevaluates these and related propositions. This reevaluation is done not with the objective of recommending specific changes in existing mechanisms for income support for the unemployed—though there may be some lessons to be learned—but to contribute to the general discussion that will gather steam as countries in the region reassess whether the mechanisms they employ are indeed appropriate for the types of product, labor, and financial markets they have, and the types of aggregate and microeconomic risks faced by workers and firms. In particular, we provide some tools and techniques to policymakers to determine the suitability and adequacy of the alternative programs of income support for the unemployed by asking the questions: Do individuals have effective instruments of comprehensive insurance against the risk of unemployment, that is, market insurance, self-insurance, and self-protection? If not, are government programs providing the missing instruments?

### **Self-Protection: The State of Labor Markets**

The logical first step in examining whether enough is being done to help workers deal with unemployment shocks is to determine if more can be done to reduce the probability of these shocks. In the terminology of Chapter 3, this constitutes the set of government actions to aug-

ment self-protection, or lower the probability of occurrence of crises or shocks. Chapter 4 discussed the monetary, fiscal, and capital market policies that will help lower the frequency and size of economic crises, including unemployment of workers. This section discusses another important set of public policy measures in this regard: labor market reforms.

Each country has a unique social consensus on the desirable balance between economic efficiency and social equity, and labor policies straddle both concerns. Different economic and political histories of countries can result in significant differences between the impact of seemingly identical laws on wages and employment, so that the subset of binding laws—and hence the labor reform agenda—is country specific (see Box 6.3). Here we simply note that labor market reform has lagged behind other economic reforms in most countries in the region, with only a few exceptions such as Chile. In fact, it has been described as the “forgotten” economic reform in LAC (Edwards and Lustig 1997), or a major component of an unfinished agenda of “second generation reforms” in the region (Guasch 1999a). For governments that wish to facilitate comprehensive insurance decisions by their workers and households in a rapidly changing global economy, labor market reform should get high priority.

### **Self-Insurance: Individual Savings Accounts**

Programs where a specified part of a worker's salary is set aside in an account—generally held in a government-approved financial institution, sometimes with guaranteed rates of interest as in the case of Brazil's *Fundo Garantia por Tempo de Serviço*—are a form of forced self-insurance. Since governments cannot credibly state that they will not “rescue” people who did not save enough, people may not save enough on their own—hence the need to make the program compulsory (Coate 1995). The main drawback of these programs is that they do not involve pooling of unemployment risks, and hence lead to lower consumption and investment by households than traditional unemployment insurance programs that are more “pay-as-you-go” in nature (see Gill, Haindl, Montenegro, and Sapelli 2000 for more on this distinction). While this may not lead to reduced welfare for wealthier households, poorer workers would suffer more. Their main strengths are that they minimize disincentive effects on work that are unavoidable in programs that involve pooling, make severance benefits

## BOX 6.3

**Labor Markets: Latin America's "Forgotten Reform"**

This box describes the four main lessons of a recent study (Gill and Montenegro 2000) that quantitatively assesses the main labor market issues in Argentina, Brazil, and Chile.

*Labor Policy Issues are Country Specific*

Ironically, the first general lesson is that regional generalizations about labor policy are often pointless or misleading. There are no shortcuts: implementable labor policies must be designed by understanding labor markets country by country. For example, there is evidence that a large number of workers are paid exactly the legal minimum wage even in Brazil's "unregulated" sector, and adjustments in this wage are matched by salary adjustments. It is possible—and indeed has been confirmed—that in some other countries minimum wages are not binding even in the regulated sector; but it would be unwise to assert either that minimum wage legislation is not important for economic outcomes or that it is important for all or most countries. Again, the finding that sustained growth in Chile has not been associated with increasing earnings inequality does not guarantee similar results for other countries; it merely weakens claims by people who question the desirability of growth-oriented labor policies instituted during the 1980s in Chile.

*Labor Outcomes Depend only Partly on Labor Policies*

Labor reform is neither necessary nor sufficient for improving labor outcomes. As the experiences of Argentina, Brazil, and Chile show, successful stabilization unaccompanied by changes in labor policy in general improves labor outcomes, though it also unmasks microeconomic imbalances (public-private compensation differentials in Brazil, relative prices of labor and capital in Argentina, and the gaps between the rich and poor in Chile). Similarly, fiscal adjustment could also improve employment and earnings outcomes, illustrating that actions such as putting government finances in order can improve outcomes in the private labor market, even if no labor reforms take place. Further, moving from a period of adjustment to sustained economic growth will improve earnings and employment outcomes, even if there are no accompanying improvements in labor policies. However, this does not mean that outcomes could not be better still if appropriate labor reforms are made, though it is harder to make this case persuasively.

*Making Labor Policies Better is Difficult During Good Times*

The first corollary of the above is that it is difficult to carry out labor reforms during economic booms. In

more certain for workers, and lower transactions costs. These considerations present the challenge of balancing labor market efficiency and poverty concerns.

The framework set forth in Chapter 3 can help resolve this dilemma. Following that framework, programs containing a significant mandatory self-insurance component may be especially well suited for countries where workers face high risk, for example, those that have high average rates of unemployment. For workers in these countries—if there were no public interventions to help the unemployed—comprehensive insurance against this risk would entail a relatively large component of self-insurance relative to market insurance. Mandating such self-insurance ensures time consistency of government behavior, but does not impose forms of insurance on individuals that would be purchased only in relatively small amounts in the absence

of government (because market insurance would be available only at a high price given that the chances of a worker being unemployed are high).

While considerable variation in unemployment rates exists among LAC economies, the regionwide average was estimated to be about 10 percent in 1999.<sup>8</sup> The likelihood of becoming unemployed is anything but rare in most countries, therefore, especially for the young, the less educated, and women, as seen in Chapter 5. For these reasons, mandated self-insurance may be well suited for countries such as Argentina and Brazil that have not carried out comprehensive economic—especially labor market—reforms. By the same token, they may be less suited for countries such as Chile, where the risks of unemployment have been lowered through far-reaching economic reforms (see below). But even countries such as Argentina should

Argentina, for example, labor policies did not rise to the top of the reform agenda during 1990–94 even though unemployment was increasing steadily, because of improving wage and employment conditions as a result of successful stabilization. When the Tequila Crisis hit Argentina, unemployment skyrocketed and labor reform came to the forefront of discussions, only to recede again when economic growth resumed as fiscal and financial reforms advanced. Again, in Brazil, labor reforms only briefly dominated the political landscape when unemployment rates rose to historic levels in mid-1998 after the economy slid into a recession. When the economic slowdown proved to be less severe than anticipated and unemployment rates fell, labor policy reform was moved off the Brazilian government’s list of priorities. Finally, a decade of sustained growth and improving employment and earnings outcomes in Chile had the effect of prompting the reversal of labor reforms that may have made these outcomes possible in the first place.

#### *Quantifying Key Magnitudes can Facilitate Labor Reform*

The second corollary of the finding that labor outcomes only partly depend on labor policies is that quantification

of the likely effects of policy reform can help to advance the reforms. Labor reform is always difficult and—when attempted—reforms are usually piecemeal. In every country, there are well-entrenched labor interests, political risks for reformers are high, and proponents of reform such as employers or economists are often ineffective in convincing people of the benefits of taking risks. To help policymakers focus their efforts and explain them to the electorate, it is important to know whether labor policy changes are necessary and, if so, which aspects of labor policy are binding, which are irrelevant, and what are the likely benefits. Quantification of the benefits of labor policy reform—rather than relying only on economic growth—shows that Argentina probably has paid a high price for not reforming labor legislation between 1995 and 2000. For Brazil, again using a quantitative approach, the aspects of labor legislation that are the most important for outcomes can be isolated. Quantifying the concept of “precariousness” helps to determine that Chile may be better off leaving labor policies largely unaltered, and looking to other policy measures such as improved education quality to narrow the income gap between the rich and the poor.

not turn their backs to pooled-risk insurance schemes: pooling offers immediate poverty-related advantages and, over the longer term as labor reforms progress and unemployment rates fall, it becomes more and more preferred to self-insurance (see Box 3.1). Guasch (1999b) proposes a program that could address both short- and long-term considerations for countries embarking on labor reforms. A study at the World Bank proposes to again address the suitability of mandated self-insurance as income support for unemployment (Vodopovic 2000).

#### **“Market-Type” Insurance: Risk-Pooling Programs**

While precise conditions for the introduction of public programs are difficult to pinpoint, there are advantages of formal, public programs in addressing unemployment risk. Informal insurance mechanisms may not be effective,

because the loss of employment is often too large a shock, or may affect a large fraction of the population at the same time. Morduch (1999) argues that informal insurance, for example, through reciprocal transfers within the extended family or community, may thus be the least effective when help is most needed. Private, market-based arrangements may fail because of informational and incentive problems involved in insuring against even rare risks, toward which individuals and households have a rational inclination, versus self-insurance (the “price” of which is the same for rare and frequent losses, and self-protection, for which expenditures may yield only small payoff when the probability of the bad state occurring is already low; see Chapter 3).

While concerns that publicly provided insurance will displace some private transfers are justified (see, for example, Cox and Jimenez 1998), its introduction may improve

## BOX 6.4

**Combining Mandated Self-Insurance and Market-Type Unemployment Insurance**

Guasch (1999b) recommends combining individual savings accounts—which have the weakness that they involve no pooling of risk and are simply forced self-insurance—and conventional unemployment insurance—which runs the risk of abuse in economies with high rates of formal unemployment combined with high shares of informal employment.

The main characteristics of the proposed program are:

- Each employee is assigned an individual account in an eligible financial institution of his or her choice.
- Each month, the worker and employer deposits a fixed fraction of wages into the account.
- The money is invested in financial securities but with strong safeguards against loss of principal value.
- The account is fully portable in the event of job separation or retirement.
- Access to funds is permitted only in the event of unemployment or retirement, and monthly withdrawals are limited to a fraction of last monthly salary.
- A part of the worker's/employer's contribution goes into a general fund—administered at the firm, sector, or economywide level—to complement the accounts of workers who may not have reached amounts that would allow certain minimum amounts when separated from work.
- Minimum monthly withdrawals for a maximum stipulated period are guaranteed only for certain types of workers (for example, heads of households).
- Firing with just cause should include dismissals by the employer due to economic reasons, and legislation should be made clear and simple.

both welfare and efficiency. For example, in poorer countries the beneficiaries of private transfers are often the elderly, and keeping more income for themselves would enable the young—who may also be poor—to invest more in their own education and health and that of their children (Morduch 1999). Public systems may also be more

efficient because they can pool resources across larger groups.

*Severance Pay Provisions as Insurance for Unemployment*

The most common form of public unemployment insurance in most of Latin America has been mandatory severance pay provisions, such as those evaluated in depth by MacIsaac and Rama (2000) for Peru. Though not generally associated with “market insurance” that involves pooling of risks, these programs in fact do pool risks to provide insurance in the event of unemployment (with the employer and/or all workers paying an “insurance premium” through reduced salary and benefits while employed). The problem is that because the employer is responsible for severance pay, the pooling is at the level of the firm, and hence the risk is spread over only a small group. In the old economic environment protected by trade barriers, the risks were effectively pooled over a greater population because consumers effectively subsidized potentially bankrupt firms through higher prices. With globalization and reduced barriers to trade, however, this is no longer possible because products must be sold at world prices.

If this scheme had proved to be administratively uncomplicated relative to other options, there might still be a reason to recommend the use of severance pay provisions. But, as pointed out in Rama and Maloney (2000), most of the grievances handled by labor courts in Latin America are in fact related to disputes over severance pay. Employment adjustments needed for economic reasons are rendered complicated, and workers are deterred from seeking better job matches voluntarily. These mandates may therefore be the worst among public “market-type insurance” programs: they involve high moral hazard with little pooling of risks, and may discourage hiring in the first place and hence raise the risk of unemployment for those looking for jobs. They exist in most countries in the region even today; these countries may be well advised to seriously reevaluate the suitability of these mandates in relation to other alternatives for ensuring income support for the unemployed.

*Public Works Programs as Insurance for Unemployment*

Again, though generally not regarded as “market-type” insurance that involves pooling of risks and the charging of

premiums, public works programs of the type analyzed above can in principle be treated as such.<sup>9</sup> The question addressed here is whether these programs have fulfilled this role in the LAC region and whether there are any lessons for the future.

The main strength of these programs is that if properly designed as a “work guarantee” (low wages, no rationing, low nonlabor costs—see Ravallion 1999) they serve effectively as unemployment insurance for those who formerly were employed (in formal or informal jobs) and for households the coping strategy of which is for family members to begin working when the main earner becomes unemployed.<sup>10</sup> The experience in the region and outside shows that these programs are able to target the poor when designed specifically for this purpose.

Both Ravallion (2000) and Snyder and Yackovlev (2000) confirm that some leakage to the nonpoor makes for resilience in social programs during economic contractions. But the results for Argentina’s *Trabajar* suggest the program was clearly subject to the same constraints in the political economy that influenced the incidence of past fiscal contractions in Argentina. The program expanded into poor areas when the budget increased, but it retreated from poor areas when the budget was cut. It was the program’s disbursements to nonpoor areas that were protected.<sup>11</sup>

Further, as Maloney (2000) argues, there is a question about the cost-effectiveness of these programs and, even more fundamentally, the proper means to evaluate them. Measured against other income protection programs considered here which seek primarily to transfer income to households experiencing shocks, the emphasis on employment through infrastructure projects means that a large fraction of the funds earmarked for income protection may be diverted to materials and capital costs. In noncrisis periods, these projects may be socially valuable when evaluated at the market rate of discount. During crises, however, when poor families facing credit constraints strongly discount the future, they represent a diversion of resources away from present income transfers that is socially costly.<sup>12</sup>

In this regard, Chile and Mexico appear to place a high value on the transfer and less on the investment per se, so that they reach rates of transfer close to 70 percent (see Wodon 2000). Argentina and Colombia seem to value the project component more, so they transfer 40 percent or less. This implies large differences across countries in the

cost per transfer and in the cost per job created, with no obvious implications for policy. In other words, these programs appear to aim at a combination of objectives—income smoothing, employment per se, provision of infrastructure—which makes difficult the comparison of workfare to other income support programs. Training programs, such as *Probecat*, can be seen as a special case of such programs where the investment is now in human capital rather than infrastructure. Since materials costs are low, the rate of transfer is very high.

### “Conventional” Unemployment Insurance

One of the more attractive features of a well-designed unemployment insurance program is that it can simultaneously help offset (part of) both microeconomic and macroeconomic fluctuations. In a study of the political economy aspects of social insurance and transfer programs in the U.S. and Latin America, Snyder and Yackovlev (2000) conduct cross-section, time-series analysis on 45 program-groups in the U.S. during 1962–98. Part of the analysis focuses explicitly on what happens during the economic cycle and major political changes, contrasting spending levels just prior to recessions with the levels during recessions. One of the findings is that the *only* class of programs which show a clearly countercyclical pattern of spending are those classified as “income security programs” (for example, social security, family assistance, food stamps, and unemployment insurance). Most of the other social protection functions exhibit no clear pattern, and some show evidence of *procyclicality*. Overall, spending on social protection program-groups appears countercyclical, but the most countercyclical program in the U.S., by far, is unemployment insurance.<sup>13</sup>

Most observers would probably not find this surprising—as unemployment rises during a recession, unemployment insurance expenditures should rise as well. But it is not unreasonable to expect that in the fiscally constrained atmosphere of a recession, unemployment benefits might be cut or eligibility constrained, so as not to “bust the budget.” Evidently, this does not occur in the U.S. Instead, a 1 percent increase in unemployment leads to somewhat more than a 1 percent increase in unemployment spending. This “automatic stabilizer” function makes it worthwhile to examine unemployment insurance programs more closely, especially that of the U.S., which has several other attractive features as well.<sup>14</sup>

Traditional unemployment insurance is usually financed through contributions by employers and/or employees, though government subsidies—either to cover deficits or to fund programs such as means-tested unemployment assistance—are usually significant. Table 6.7 shows the extent of burden-sharing in the financing of UI (Gill, Dar, and Thomas 1999, based on data reported in Tzannatos and Roddis 1998). In only 10 countries is the burden entirely borne by just one party. Brazil, where only employers contribute to UI financing, is the notable example of such countries in LAC. Burden-sharing between two parties is more prevalent, especially between employers and employees. In 13 countries, including Argentina, Ecuador, and Venezuela, the burden is shared by both. In Argentina, the UI program is financed by a 1.5 percent payroll tax on employers and a 1 percent tax on workers' wages (Mazza 1999). The most prevalent means of financing UI systems is through contributions by all three parties, with 38 countries financing their UI system through these means. In 17 of these 38 countries, the role of the government is limited to just paying off any deficit.<sup>15</sup>

Under most scenarios, it is difficult to justify large-scale permanent subsidization of unemployment insurance programs by the government. The insurance aspect of the scheme implies that benefits should be paid from contributions. One exception is, perhaps, the cost of administering UI programs; it is reasonable to expect the government to pay the administration costs of a system that it has set up, especially if it wishes to significantly influence its

design. The U.S. federal government, for example, pays state governments for administration costs. Countries such as France, Germany, and the U.K. also pay the administration costs of UI programs, while not subsidizing payments to UI claimants. Another exception may be the payment by government of social security dues on behalf of the unemployed during the period he or she is eligible to receive unemployment insurance benefits—for example, in Germany and Portugal—though in principle this could also be financed from UI contributions. It is easier to justify government subsidies, for assistance, to those among the unemployed who are poor, determined through reliable means-testing. Under such a system, the government pays for modest benefits for those where the main eligibility criteria are not proof of past contributions and current involuntary unemployment (as required for unemployment insurance), but proof of current poverty (which is fundamental) and of current involuntary unemployment (which is secondary). Governments in Austria, Finland, France, and the U.K. finance unemployment assistance along these lines.<sup>16</sup>

Table 6.6 provides information on who among workers or employers is *legally* responsible for contributing to the scheme on behalf of workers. Who actually pays—in more general economic terms—is a far more complicated question, the answer to which depends on the design of the program and the relative market power of workers and employers, both of which are country-specific considerations (see Box 6.5). The relative market power of employ-

TABLE 6.6

**Costs of Unemployment Insurance: Burden-Sharing Among Workers, Employers, and Government**

PAID BY	OECD	LATIN AMERICA AND OTHER	TOTAL NUMBER
Worker only	None	None	0
Employer only	Iceland	Bangladesh, <i>Brazil</i> , Moldova	4
Government only	Australia, New Zealand	<i>Chile</i> , Estonia, Hong Kong, Tunisia	6
Employer and government	Italy	Bulgaria, China, Georgia, Russia	5
Employer and worker	Canada, Greece, Netherlands, Sweden, U.S.	Algeria, <i>Argentina</i> , <i>Barbados</i> , <i>Ecuador</i> , Hungary, Serbia and Montenegro, South Africa, <i>Venezuela</i>	13
Employer and/or worker; government pays any <i>deficit</i>	Belgium, Denmark, Ireland, Norway	Albania, Armenia, Azerbaijan, Belarus, Czech Rep., Egypt, Iran, Lithuania, Poland, Romania, Turkmenistan, Ukraine, Uzbekistan	17
All three; government's contribution is <i>nonresidual</i>	Austria, Finland, France, Germany, Japan, Luxembourg, Portugal, Spain, Switzerland, U.K.	Croatia, Cyprus, Guernsey, Israel, Kyrgyzstan, Latvia, Liechtenstein, Malta, Slovak Rep, Slovenia, <i>Uruguay</i>	21

Note: Turkey and *Mexico* are the only OECD countries without formal unemployment insurance systems as defined in this paper.

Source: Tzannatos and Roddis (1998), using data reported in *Social Security Systems Throughout the World—1997*, published by the U.S. Social Security Administration.



BOX 6.5

**Who Really Pays for Unemployment Insurance?**

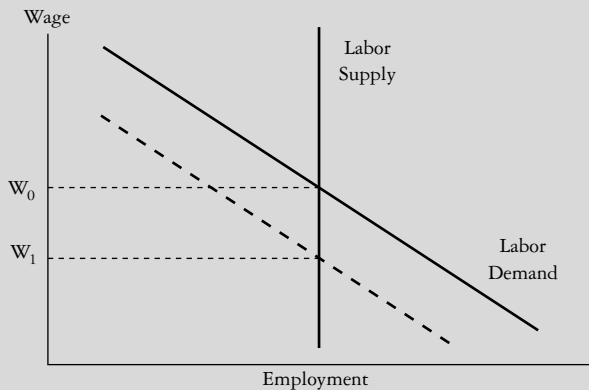
Who bears how much of the burden of contributions to formal unemployment insurance depends on two factors: (a) the extent to which the design of the UI program differs from what workers would have chosen for themselves as insurance against unemployment; and (b) to the extent that some differences exist, UI contributions will be viewed as a tax, the incidence of which will depend on the demand and supply elasticities of labor (see Gill, Dar, and Thomas 1999).

If the government-sponsored UI program is exactly what every worker would have chosen by themselves, then the cost will be borne entirely by the worker (who will willingly accept a wage net of all UI contributions). If—as is likely—the government program is different from the insurance against unemployment the worker would buy privately, the tax burden will in general be shared by the worker and the employer. The higher the elasticity of demand for labor, other things being the same, the larger the share of the tax borne by the worker. The higher the elasticity of supply of labor (or the ease of becoming informal), the higher the share of the tax borne by the employer. Who actually pays (that is, bears the incidence) therefore depends not on whom the tax is levied but the design of the scheme and the relative market power of the worker vis-à-vis the employer.

Figures 6.1 and 6.2 illustrate this point. Figure 6.1 shows the effect of imposing a UI contribution on employers in a labor market in which the supply of labor is highly inelastic. This has the effect of reducing the labor demand of firms at any given wage (the demand curve shifts down by the amount of the employer contribution). In the new equilibrium, after the imposition of the UI contribution, workers receive a wage which is lower by the amount of the contribution  $w_1$  (as opposed to the previous equilibrium of  $w_0$ ); employers end up paying the same gross wage as they did before. In other words, the fact that the contribution is nominally raised on employers makes no difference to the outcome, which is that workers end up paying, just as they would have

FIGURE 6.1

**Workers Pay for UI even Though the Contributions are Levied on Firms**

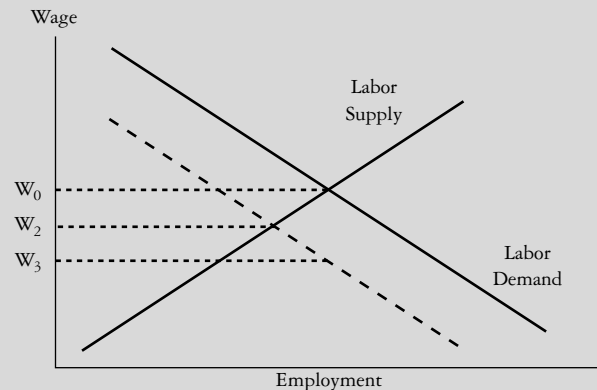


done if the contributions had been raised directly from their paychecks.

Figure 6.2 shows the outcome of an employer contribution if the supply of labor is more sensitive to the

FIGURE 6.2

**Workers and Firms Share UI Costs even Though Contributions are Levied on Firms**



wage. Now the incidence is shared. Rather than falling all the way from  $w_0$  to  $w_1$ , the supply response pulls the wage back up to  $w_2$ . Workers still “pay” for a part ( $w_0 - w_2$ ) of their UI contributions by receiving lower wages, while employers pay the difference ( $w_2 - w_1$ ).

ers and workers is not something the government should try to influence, but the design of the program should be

of central importance to government. In this regard, the key question is how well the program’s design “mimics the

TABLE 6.7

**Income Support Programs for the Unemployed: Summary of Findings and Policy Implications**

MEASURE	NATURE OF INSTRUMENT	ADVANTAGES AND DISADVANTAGES	POLICY IMPLICATION
Individual savings accounts	Self-insurance—no pooling of risk	Low labor market efficiency costs, but welfare reduction especially for poorer workers.	Should be considered by countries that have high unemployment, especially where labor reforms are only a distant possibility.
Severance pay	Pooling over small group—globalization makes group even smaller	Almost no advantage. Little pooling of risk, entails labor market inefficiency, makes labor relations contentious, and is administratively challenging.	Possibly the worst form of unemployment support in a globalized economy.
Public works and training programs	Market-type insurance elements—implicit pooling of risk	Can reach informal sector workers and the poor, but can entail high leakages in the form of nonlabor costs when investment element is made a priority. Training programs show less leakage but also lower coverage potential.	Should be considered for a part of work force, but not a universal scheme. Permanent schemes allow for better balance between consumption smoothing and investment over the economic cycle.
Unemployment insurance	Market-type insurance—explicit pooling of risks	Most pooling of risk, can be used both to address idiosyncratic and aggregate risk, and hence, serve as a “automatic fiscal stabilizer.” Generally politically popular. May be administratively demanding.	Should be considered by governments that have carried out comprehensive economic reforms; labor market disincentive effects can be reduced by keeping benefits frugal and “mimicking the market” as much as possible in design.

market.” One of the principal features of private insurance markets is that the price reflects the degree of risk, even if imperfectly. This is a noteworthy feature of the U.S. system, perhaps the only one that tries to match unemployment tax rates to risk through employer “experience-rating,” where rates of tax vary according to the frequency with which an employer’s former workers have filed for unemployment benefits.<sup>17</sup> Mimicking the market, and more particularly, the insurance that workers would choose to buy, is also essential to the long-run goal of covering the informal sector. If wages fall to reflect the cost of insurance that workers do not want, then they have the incentive to avoid the implicit “tax” and become informal (see Maloney 1998).

The U.S. unemployment insurance program may be a good model for LAC countries that are considering such systems: there are minimal mandated severance pay rules under the general labor laws, the system mimics the market as much as countrywide public systems can, benefit level and duration are modest, the rules are relatively uniform throughout the country even though states collect taxes and pay benefits, and the design of the program in general makes it an automatic fiscal stabilizer. While this role may not be large in quantitative terms, the program

stands out as a rare government program that is strongly countercyclical in nature.

There are several ways to move from the current systems of mandated severance pay to such unemployment systems. Coloma (1996) proposes an unemployment insurance system for Chile—which has severance pay provisions but is considering the introduction of a new system—that uses severance pay benefits as a “deductible.” Under this proposal, the unemployed would first have to draw down the accumulated severance benefits, and only then have access to unemployment insurance payments. The effort to make the hybrid system resemble the structure of private insurance schemes—where the insured are not paid the full loss but the loss minus a deductible—makes the proposal an improvement over a system of mandated severance pay. Following the line of reasoning developed in Chapter 3, countries that have low unemployment risks because of comprehensive economic reforms and strong information systems, (for example, strong administrative data and regular households surveys), have the “insurance fundamentals” that make for moves toward unemployment support systems that pool risk to be welfare-increasing for its citizens, even when some efficiency losses are involved. For countries such as Brazil, that already have minimalistic

unemployment insurance systems but may or may not have these preconditions, Box 6.6 provides some tentative guidelines.

## Conclusion

This chapter summarized the experience in five countries with five types of income support programs for the unemployed, and then drew some policy lessons. While it is difficult to determine an unambiguous ranking of these programs independent of country-specific circumstances, these experiences, combined with the comprehensive insurance

framework presented earlier in the report, do provide for some broad but potentially useful guidelines.

Table 6.7 presents these findings, which draw from both theoretical considerations and the regional experience. They should be viewed as a starting point for closer policy analysis from a country-specific perspective. With this objective, the table casts each available policy instrument in the general framework of Chapter 3 and notes their respective advantages and disadvantages. Based on this, the rightmost column of the table outlines the conditions under which each instrument may represent an appropriate policy choice.

### BOX 6.6

#### Some Guidelines for Countries that Have Unemployment Systems

International experience appears to suggest the following lessons for LAC economies that currently have unemployment insurance (UI) systems, but which cover only a small fraction of the workforce.

*It does not appear necessary to extend the UI tax to workers.* Having a levy only on employers is in line with international experience in the OECD and middle-income countries. Besides, economic theory suggests that the final burden of UI taxes has less to do with who bears the initial impact and more with the design of the scheme and the elasticities of demand and supply of labor.

*Keep the role of government in UI finance minimal.* Governments should pay only for the costs of administration of the UI system. This is in line with international experience, and in keeping with the principle of employers and employees together insuring workers against drastic income loss during unemployment.

*Frugality of benefits should be maintained.* Because of the high degree of informality, it is difficult for the UI agency to determine if claimants are in fact unemployed. Keeping a waiting time of about 30 days before benefits commence and the benefit levels low—as Brazil has succeeded in doing so far—circumvents this problem somewhat and also reduces work-related disincentives associated with all UI systems. Financing a more generous UI system will also be difficult because it will be impossible to make a large number of employers and employees pay their contributions.

*Decisions on the tax base should be made on administrative grounds.* The decision on the tax base should be

made on grounds of administrative ease for both government and employers. Ideally, the base should be the same or similar to that used for other taxes collected. Thus, if the system is administered by states, the tax base should be the same as that used for other state taxes. If the system is federally administered, there may be grounds to make the tax base the same as that used for the main federal tax on employers, usually the social security tax.

*Experience-rating of employers can be a reasonable medium-term goal.* While experience-rating has many attractive features, it is administratively demanding. Before making any decisions in this regard, countries in the region would be well advised to seek technical assistance from experts in the U.S., especially UI administrators from states that have relatively recently and successfully instituted experience-rating.

*Government financing of unemployment assistance could be considered.* Most countries in the region have a high degree of informal employment, often synonymous with noncompliance with social security laws. The region confronts the challenge of extending income support to those in the informal sector as economies are opened up to the rigors of international competition. One option could be for the government to finance a system of unemployment assistance with low, uniform benefits to those who are currently unemployed and who satisfy a means test, do not qualify for unemployment insurance because their employers have not paid UI taxes, but who can prove that they have contributed their social security dues for the same length of time as required for UI eligibility.

However, a major conclusion of this chapter is that in designing an effective strategy to help workers deal with the risk of unemployment, administrative capacity should be an important but not overriding concern of government. Most countries in the region are capable of building this capacity. The more important questions are whether there are government actions that can rapidly lower the risk of unemployment, and what are the type of unemployment support programs that are in demand but the supply of which is constrained. These questions can be posed as follows:

- What are the measures that would augment the *self-protection* efforts of workers—that is, reforms that lower the risks of unemployment? Labor policy measures are a leading candidate, though their importance and nature have to be decided by each country.
- What are the most practical measures to augment *market-type insurance* involving pooling of unemployment risks? These measures invariably imply efficiency costs but suit countries better and better as they successfully implement self-protection-augmenting policies that lower the risk of unemployment.
- What are the most practical measures to augment *self-insurance* efforts of workers? These measures generally minimize labor market distortions and best suit countries where self-protection augmenting efforts are underway, but may require that special attention be paid to poorer workers.

While the relative weight on each of the three measures will differ across the economies in the region, a sound policy mix involves pursuing all three objectives so that workers obtain not a full guarantee against all shocks, but comprehensive insurance that allows them to seize the opportunities presented by globalization, and to see that risk is a fact of life in a world that grows smaller every year.

## Notes

1. Argentina, Barbados, Brazil, Ecuador, Uruguay, and Venezuela have unemployment insurance programs, though some of these are quite limited in scope.

2. Chile is currently debating the merits and demerits of introducing individual saving accounts for dealing with the risk of unemployment.

3. Only for public works programs was there a substantial literature available (Ravallion, 1990; Ravallion, Datt and Chaudhuri, 1993; Datt and Ravallion, 1994). For other income support programs, and with a few exceptions (Cunningham, 1997; Kugler,

1999a and 1999b; Wodon and Minowa, 1999), the literature is much more scant.

4. The chapter also draws from a series of independently produced studies dealing with one income support program in Argentina (Ravallion 1999a, 1999b, and 1999c; Jalan and Ravallion 1999; Jones and Ravallion 1999).

5. Sections 2 and 3 of this chapter are based on Rama and Maloney (2000).

6. In 1999 the monthly minimum salary was less than \$100.

7. It follows that the public works program is not merely displacing other, roughly equivalent ways of generating income. Ravallion does assume, however, that jobs displaced are lost and not taken by other unemployed. Relaxing this assumption would lead to higher estimates of benefits to the target population.

8. Countries such as Argentina have rates as high as 15 percent, while those in Chile are less than half these rates.

9. Programs with large transfer elements can be treated in an insurance setting as market-type insurance with a negative loading factor, that is, those for which the price of insurance is better than actuarially fair.

10. Montenegro and Gill (2000) and others find that in the 1980s a large share of the participants of Chile's Minimum Employment Program were formerly out of the labor force.

11. Given the low wage rate offered, the direct benefits from the program are still likely to have favored the poor, even after the cuts. Thus, the design features of the program undoubtedly helped protect the poor from cuts.

12. This diversion may be justified by appeals to the dignity of work, or avoiding the adverse social consequences of mass unemployment, although such considerations tend to receive less discussion when programs affecting middle-class workers are discussed. From the political economy perspective, governments may also be more willing to finance investment projects than simply transfers, or even workfare projects that have low materials costs and are essentially recurrent in nature (maintenance, cleaning, repairing). In this case, benefits to the unemployed may be higher when packaged in an investment project than simply as a transfer.

13. Another important finding in Snyder and Yackovlev (2000) is that there is a difference between programs that are targeted at the poor and those—such as unemployment insurance—that are not; that is, spending on programs that are targeted at the poor is much more sensitive to party control in Congress than spending on non-targeted programs.

14. Gill, Dar, and Thomas (1999) summarize the features that lead to this strong countercyclicality as (a) stringent legal restrictions that unemployment tax proceeds can be used only for paying unemployment benefits, (b) established rules by which the federal government provides loans to states whose UI trust funds are drying up, and (c) rules that the federal government uses its own UI trust fund to extend unemployment benefits during long recessions—the maximum duration can be doubled to 26 weeks.

15. While in some countries the government may directly contribute into the UI fund (for example, Israel, Japan, and Malta),

more often this may involve the government's financing of means-tested unemployment assistance programs (for example, Austria, Finland, France, and the U.K.), social insurance programs (for example, Germany and Portugal), or even active labor market or social assistance programs (for example, Latvia and the Slovak Republic).

16. The main difference between unemployment insurance and unemployment assistance is that the eligibility condition for insur-

ance is time of contribution, while eligibility for assistance is based on a means test that qualifies the recipient as needy.

17. Note again that, given the design of the program, who actually pays the contribution does not depend on whom the tax is levied. In essence, the U.S. system transfers the problem of determining unemployment risk onto the employer. Thus employees who have filed for UI benefits more frequently are likely to be less attractive to future employers.