

A New Labor Policy Agenda

The labor market fulfills two parallel functions—allocation of resources and allocation of incomes—at the center of everyday market exchanges. All kinds of policies affect the labor market and, in turn, labor market performance affects outcomes in other policy areas. Growth is a fundamental force affecting the performance of the labor market; after all, the demand for labor is derived from the demand for the goods and services labor produces.

The mix and orientation of the policy instruments that have been used to affect labor market outcomes in Latin America and the Caribbean have not been static. In the 1970s and early 1980s, fiscal policy, particularly investment in large public projects, was the favorite tool for fighting unemployment. In the high-inflation 1980s, wage indexation policies and modest targeted employment programs were used to dampen the impact of low growth on the labor market. During the 1990s, when financial constraints forbade the use of fiscal policies, attention turned to the reform of labor regulations that increased labor costs for firms.

In spite of this variety of policy efforts, labor market outcomes in the region have been unsatisfactory. These outcomes are the product of more than labor policies. The preceding chapters of this volume have discussed in depth how labor market performance is affected by demographic trends (chapter 3), macroeconomic policies (chapter 4),

the structural reforms of the 1990s (chapter 5), and technological change or lack thereof (chapter 6). Chapter 7 discussed the impact that labor regulation and institutions have on the performance of the labor market. This chapter returns to the discussion in chapter 2 on the reallocation of jobs and workers. It focuses on the set of policies needed to facilitate the labor market task of allocating resources and earnings across workers and firms.

These facilitating policies will operate in a volatile macroeconomic environment. Although monetary and fiscal policies are not as much of a source of instability as they used to be—during the 1990s they exhibited substantially lower volatility than in previous decades—other sources of volatility persist. The first section of the chapter briefly discusses some of the suggested policies for lowering volatility by reducing exposure to external shocks and improving the set of domestic policies that countries can use to deal with these shocks. The main point is that many of these macro policies involve structural changes—and as such are unlikely to have immediate effects on instability. Furthermore, falling inflation rates in many economies of the region may lead to higher real wage rigidity (as discussed in chapter 4) and therefore may deepen the unemployment effects of adjustment to external shocks. Thus, this section also explores some innovations in labor market policies that may help to minimize the

negative effects of this unstable macroeconomic setting on labor market outcomes.

As the discussion about job and worker dynamics in chapter 2 explained, most of the action in the labor market happens around the flows of job creation and destruction, and it is at this level that labor policies need to operate. These flows involve a vastly larger number of workers than those who are unemployed; typically, relocation involves one-fourth of the total number of jobs in each period, a much larger number than the average 10 percent unemployment rate that is usually observed in the region. Even more compelling, normal job churning dwarfs the effects of macro and financial crises on worker and job relocation (see chapter 2).

The main normative message of this chapter is that labor policies should evolve away from the philosophy of “protecting the worker from the power of employers” that has often inspired the institutional design of labor policies in the region. Policies should instead facilitate the labor market’s task of allocating resources and earnings across workers and firms.

This does not imply that workers’ rights (both individual and collective, as established in conventions on core labor standards and in national labor codes) are not important. In fact, if anything, the status quo of implementation and enforcement in the region *de facto* ignores core labor standards, using a “better not to enforce bad regulations” justification. Rule of law is a social asset that is depreciated through noncompliance with regulations and should be taken more seriously. Reversing the past decade’s degradation of the regulatory and enforcement function is a necessary condition for effective labor policy. Regulations can and should change, as discussed in chapter 7.

Switching labor policies toward a facilitating role implies far-reaching institutional changes. Countries in the region spend 0.5 percent of gross domestic product (GDP) on income support policies that operate through the labor market; OECD countries spend at least double that (Verdera 1998; OECD 1998). Given the modest amount of resources available in Latin America, the development of new public-private partnerships in the

design and implementation of labor policies is crucial.

What would this new approach encompass? The vision that emerges from the discussion in this volume is a complex network of public and private institutions that fill four specific functions: (1) increasing the efficiency of matching, (2) adequately insuring workers against the risks of job churning, (3) enhancing the opportunities of workers by increasing their skills, and (4) enforcing regulations. With the exception of the insurance function, these are structural functions. That is, they entail expenditures and offer services that are permanent and independent of business cycles. The insurance function is highly countercyclical by design and therefore should adjust through the cycle. However, because services include cross-referral between income support, training, and intermediation subsystems, the whole system should exhibit countercyclical behavior.

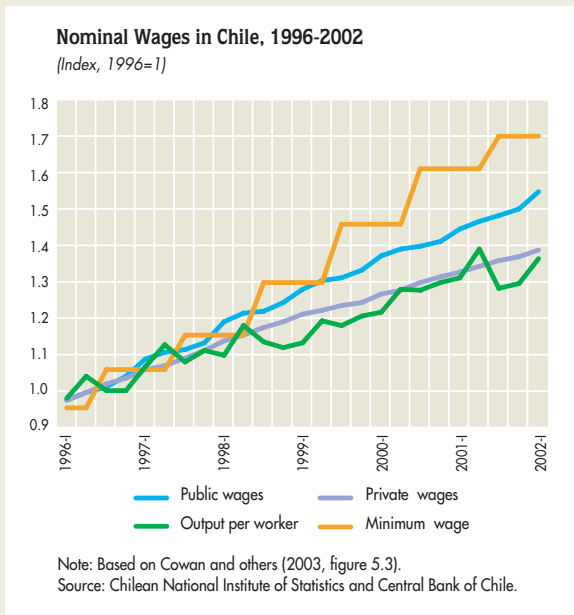
However, the behavior of current fiscal and social policies hinders the task of insurance that, by definition, implies transferring income between good and bad times. The last section of this chapter discusses possible mechanisms to overcome the macroeconomic and political constraints that generate this procyclical behavior. In the long run, Latin American countries would likely benefit from a more developed welfare state, both through more macroeconomic stability and less risk for the population from unexpected shocks. However, in this process it is essential to bring in the lessons and avoid the mistakes made by those countries that began this process earlier.

DEALING WITH MACRO VOLATILITY

One of the main findings of chapter 4 is that when faced with a negative aggregate demand shock, Latin American countries have tended to adjust more through real wages and less through employment compared with developed countries. At the same time, falling inflation may have reduced this real wage flexibility, increasing the unemployment cost of recessions. The first line of defense against this vulnerability is to reduce the exposure to external

Box 8.1 Administratively Determined Wages and Wage Rigidity in Chile

A recent study by Cowan and others (2003) evaluates the impact of public sector and minimum wages on private sector wages in Chile in the past two decades. The figure below plots the behavior of an index of nominal wages in the private sector, an index of wages in the social and community services sector (a proxy for public wages), average output per worker in the economy, and an index of the minimum wage. The first fact that stands out is the high rate of



growth in minimum wages, in particular during 1997-2000, when growth slowed down and unemployment picked up. Public sector wages also grew significantly in this period, more than private sector wages in fact. Real wages outran average productivity in the initial quarters of the slow-down (the third quarter in 1998). Neither minimum wages nor public wages fell after the economic slow-down.

Did the high growth rate in minimum and public wages influence the downward rigidity of private sector wages in Chile? To answer this question, the authors carried out two exercises. First, they used data from household surveys to evaluate the impact of the minimum wage on the distribution of wages, finding that a substantial number of workers (6 percent) were directly affected by the rising minimum wage during 1997-2002. Second, they estimated the impact of public and minimum wages on private sector wages using monthly data for 1986-2002. They find a positive and significant correlation between the minimum wage and private sector wages. However, the parameter estimates and the timing of the effects suggest that the minimum wage in Chile only has a direct effect, and does not have a significant effect on workers earning more than the minimum wage. Moreover, if the effect of minimum wages is allowed to vary across periods (1986-97 and 1998-2000), only the estimated coefficient for the second period is significant—suggesting that the minimum wage becomes a binding restriction only in the period of low growth. The authors also obtain a positive correlation between private and public wages, although this coefficient is not significantly larger than zero at conventional confidence levels.

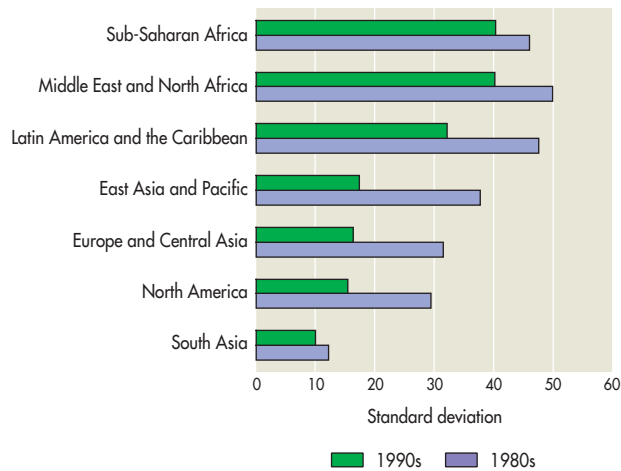
shocks and the impact of those shocks on the domestic economy. Because these policies are structural and therefore unlikely to have an effect in the short run, another set of policies needs to be adopted to deal with other sources of rigidities that arise from the cost of wage renegotiations and the consideration of labor contracts as an insurance device.

In addition to nominal rigidities that arise from the structure of wage contracts, wages set by governments—minimum wages or public sector wages—may also have an effect on wage rigidity. Both of these have a direct effect on those workers who receive the set wages, and may also have an indirect effect on the rest of the economy by affect-

ing the opportunity cost of private sector workers. The effect of the minimum wage on wage rigidity will depend on the level of enforcement and on whether it constitutes a binding restriction. The effects of public sector wages will depend on the relative size of the public sector and the degree of worker mobility between the public and private sectors. Box 8.1 discusses the effects of these policies in Chile.

Reducing Exposure to External Shocks

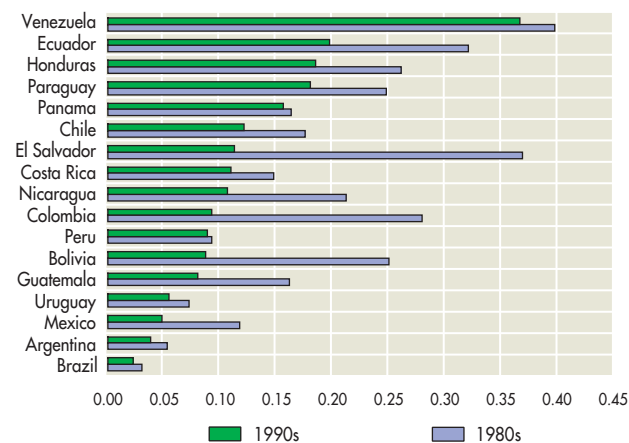
Although terms of trade volatility in Latin America has fallen over the past two decades, it is still con-

Figure 8.1 Volatility of Prices of Main Export Products

Note: Volatility is defined as the standard deviation of the annual price index of exports per decade. The main export products are the five SITC categories (3-digit, rev. 2) that make up the largest shares in each region's exports.
Source: IDB calculations based on World Integrated Trade Solution data from the World Bank.

Figure 8.2 Concentration of Exports

(Hirsch-Herfindal index, 0-1)



Note: The Hirsch-Herfindal index is calculated over 3-digit (rev. 2) SITC exports. Sample size is determined by data availability.
Source: IDB calculations based on World Integrated Trade Solution data from the World Bank.

siderably higher than that of East Asia and the developed countries (see chapter 4).¹ This high volatility of terms of trade is at least in part the result of low export diversification and a high share in total exports of goods with above average price volatility (see Figure 8.1). Although export diversification has been increasing in the region in the past decade (see Figure 8.2), further progress in

this area is a necessary condition to reduce exposure to large fluctuations in external demand.

In addition to exposure to large fluctuations in external demand, weak international links limit the capacity of countries in the region to accommodate these temporary demand shocks. These weak links are reflected in the high volatility of capital inflows to the region.² Indeed, capital flows are often a shock in and of themselves. Sudden reversals of capital inflows, or “sudden stops,” have large costs in terms of output and employment. There is widespread consensus on a series of medium-run structural policies aimed at improving external financial links. These include norms of transparency and accountability, and adequate supervision of the banking sector and other financial intermediaries—all measures aimed at improving the contractual setting and the quality of corporate governance. In addition to the domestic policies mentioned above, there is a growing debate on the importance of “international insurance mechanisms” in reducing capital flow volatility. These proposals run the full range from state contingent debt (see Borensztein and Mauro 2002), to contingent credit lines (see Caballero and Panageas 2003), to the privatization of state-owned companies (see IDB 1995).

Reducing the Impact of Shocks

As argued by Calvo, Izquierdo, and Talvi (2002), greater trade openness will reduce the costs of a reversal of capital inflows by limiting the size of the real exchange rate adjustment required to accommodate a given shock. Trade openness has increased in the region (from close to 22 percent of GDP in the early 1970s to more than 30 percent of GDP in the late 1990s). Nevertheless, this expansion has been smaller than the growth of capital inflows. Indeed, the ratio of the current account

¹ Based on terms of trade data from World Bank (various years), the variance of the terms of trade in the 1990s was significantly lower than that of the 1970s at conventional confidence levels.

² Table 4.1 documents the volatility of capital flows in different regions in the past three decades.

deficit to exports grew from 15 to 20 percent during the 1990s.³ Additional efforts to increase trade openness are therefore needed to reduce the effects of capital flows volatility on output and employment.

Domestic financial markets play a key role in intermediating funds for investment, and hence play an important role in enhancing long-term growth and productivity. They also play an important role in intermediating liquidity, a role that is particularly important if a country's access to international capital markets is temporarily limited. Therefore, developing the domestic financial market may help to reduce the impact of temporary shocks to external demand on output.⁴ In addition, by correctly pricing access to international capital markets, domestic financial development may also reduce exposure to capital flows volatility (Caballero and Krishnamurthy 2001). Finally, key conditions identified for the development of domestic financial markets (including adequate regulation and supervision and investor protection) are also likely to have a direct effect on international linkages.

The role of nominal exchange rates in the adjustment of relative prices (the real exchange rate) to an external shock is directly related to wage flexibility and hence to labor market policies. In a pegged regime, real exchange rate adjustments have to occur through changes in the domestic price and wage level. Shocks requiring a real depreciation—such as those experienced by Argentina after the Brazil devaluation—require a decline in the domestic price level in relation to trading partners to restore real exchange rate equilibrium. If wages and prices are rigid, the adjustment will be slow and costly in terms of output and employment. In a floating regime, by contrast, a misalignment of the real exchange rate can be quickly corrected through a change in the nominal exchange rate.⁵

A series of recent studies—inspired by the emerging market crises of the late 1990s—calls into question the central assumption that a depreciation of the exchange rate has an expansionary effect on the macroeconomy.⁶ These studies indicate that a depreciation not only has the usual positive effects on aggregate demand, but also deteriorates net worth by inflating the domestic currency value of

debt. Larger debt leads to an increase in the cost of external finance and (other things equal) to a reduction in investment.

Discussion of the optimal exchange rate policy for emerging markets must take into consideration both the degree of wage and price rigidity and the balance sheet effects brought about by liability dollarization. On the one hand, exchange rate flexibility reduces real wage rigidity in the presence of rigid nominal wage and price contracts. On the other hand, if financial contracts are indexed to the nominal exchange rate, then the stabilizing effects of real wage flexibility must be weighed against the (potentially) destabilizing effects the exchange rate may have on balance sheets.

Contracts and Renegotiations

As discussed in chapter 4, the response of the labor market to aggregate shocks depends to a large extent on the degree of real wage flexibility. This flexibility will in turn depend on the length of contracts and the indexation mechanisms included in them. With this in mind, the discussion turns to some possible determinants of contract structure and the implications of labor market policies for this structure.

Gray (1978) provides a useful framework for analyzing the determinants of labor contract length

³ Data on trade and capital flows are from IDB (2002).

⁴ Beck, Lundberg, and Majnoni (2001) provide some evidence that the development of financial intermediaries reduces the macroeconomic impact of terms of trade volatility.

⁵ Perry and Servén (2003) find that the impact of a terms of trade shock on output is significantly lower in countries with floating exchange rate regimes, suggesting that nominal price rigidities are pervasive and therefore that nominal exchange rate flexibility can reduce the output cost of external shocks by increasing the flexibility of real exchange rates. This result extends previous research by Broda (2001).

⁶ A first strand of the literature explores the macroeconomic implications of currency mismatches. In Krugman (1999a, 1999b) and Aghion, Bacchetta, and Banerjee (2001), the balance sheet effect is assumed to be large enough to dominate the expansionary effects. This strongly negative relationship between investment and depreciation can give rise to multiple equilibria, and hence the potential for an expectations-driven exchange rate crisis. The potentially destabilizing effects of a devaluation in the presence of dollar debt are also discussed in Céspedes, Chang, and Velasco (2000), although the authors emphasize that dollar debt does not necessarily lead to “macroeconomic damnation.” For a recent survey of this literature, see Cowan and Do (2003).

in the context of real and monetary shocks. She argues that firms choose the optimal contract length taking into consideration the costs of renegotiating each contract and the expected costs of having a wage that may no longer be optimal if demand or cost conditions change during the life of the contract. Therefore, if uncertainty about future demand conditions increases, firms will negotiate shorter contracts. Increasing the costs of renegotiation will have the opposite effect—lengthening contracts and introducing greater nominal rigidity. A first implication is that countries with higher costs of renegotiating contracts will tend to have longer contracts. Another implication is that a reduction in the volatility of demand or productivity will lead to longer contracts and a reduction in nominal wage flexibility.⁷ This being the case, it should be expected that contracts would become increasingly longer in Latin America if volatility were reduced.

Indexation to inflation increases the expected costs of a long wage contract if shocks are real, but reduces the costs if shocks are monetary (Fischer 1977; Gray 1978). This makes intuitive sense: if the money supply expands unexpectedly, pushing prices up, then indexed wages will adjust accordingly, leaving output and employment unchanged. For a real shock, on the other hand, indexation will limit the speed of adjustment of the real wage, and increase the effect in terms of unemployment. In the absence of legal restrictions, the degree of contract indexation will therefore depend on the perceived volatility of real and monetary shocks. Indexation will increase if the volatility of monetary shocks increases relative to the volatility of real shocks.⁸

It can be argued that wage indexation increases the cost of disinflation by increasing inflation persistence. This does not imply, however, that indexation should be restricted or removed. The benefits in terms of inflation inertia of restricting indexation must be weighed against the costs of pushing contracts away from the private optimum. Limiting indexation is likely to (1) shorten labor contracts, which will lead to higher negotiation costs, and (2) increase the effects of monetary shocks on output and employment.

Wage contracts will also be shorter, and nominal rigidity lower, if labor market regulations reduce the probability or duration of strikes—one of the main components of negotiation costs. Although a series of explanations has been put forward for strike activity, all of them appeal to some form of imperfect information.⁹ If the profitability of the firm is unknown to union members, strikes may be viewed as screening devices, which allow workers to extract higher wages from more profitable employers. A firm with higher profits prefers to settle at a high wage without a strike; a firm with low profitability would be willing to endure a strike. Policies that affect information disclosure would therefore affect the probability of labor conflicts. In more general terms, legislation that increases the quantity and reliability of corporate accounting information would have a series of benefits, in addition to reducing labor conflicts. This is not always a feasible policy, however, as many firms are not required to keep, let alone publish, accounting information. For such firms, the rules of negotiation are likely to be more important than provisions affecting information disclosure.¹⁰

Information availability is also a key component of proposals that seek to increase wage flexi-

⁷ Gray and Kandil (1991) and Kandil (2000) find evidence of this using aggregate wage data for a group of developed economies. In particular, they find that the response of nominal wages to aggregate shocks is lower in economies with lower uncertainty, which they argue is consistent with longer nominal wage contracts.

⁸ Strictly speaking, indexation is often imperfect because it is based on lagged values of growth of the consumer price index. Jadresic (1997, 1998) discusses the implications of this lagged indexation for output volatility in the context of a small open economy.

⁹ Alternative explanations for strikes are faulty negotiations (Hicks 1932) or incentives of union leaders (Ashenfelter and Johnson 1969).

¹⁰ Because of lack of data, there is scarce careful empirical evidence for emerging markets on the impact of bargaining legislation on strike outcomes. Recent empirical data for a developed economy are presented in Crampton, Gunderson, and Tracy (1999). Using data on strike activity that exploit variations in labor codes across Canadian provinces, they find that negotiation policies have had a substantial effect on strike incidence, duration, and wage outcomes. Conciliation policies have been largely ineffective in reducing strike costs, but in general contract re-opener provisions make both unions and employers better off by reducing negotiation costs without systematically affecting wage settlements. Legislation banning the use of replacement workers leads to higher negotiation costs by increasing both the frequency and duration of strikes. In addition, replacement bans also result in significantly higher real wage settlements.

bility by incorporating some form of profit sharing into the wage structure. Share wages can take the form of profit sharing, a fraction of shares, or production bonuses—indeed, any form that ties wages to firm outcomes according to a previously defined rule. This type of contract potentially has the added advantage of increasing worker productivity. (See Bravo, Larrañaga, and Ramos [2001] for a discussion of share wages and their impact on volatility and productivity.)

Why are these share contracts not used extensively in Latin America, in particular considering the highly volatile macroeconomic environment in which labor markets in the region operate? As discussed above, information requirements are one explanation. Tying wages to profits or sales requires firms to produce timely and credible accounting. The other explanation relates to risk aversion and the role of long-term labor market contracts in providing insurance to workers.

Labor Contracts as Insurance

Either because firms have better access to capital markets or firm owners have a broadly diversified portfolio of assets, it seems reasonable to consider that firms are less risk averse than workers. This being the case, both employers and employees will benefit from a long-term contract that insulates workers from fluctuations in firm profits in exchange for lower average wages (Baily 1974; Azariadis 1975). Indeed, Baily (1974) shows that the optimal contract in this setting will guarantee a steady wage to workers, giving rise to long-term fixed wage contracts.

Finally, it should be noted that all the arguments and policies discussed in this section are based on the existence of long-term work contracts and hence are closely related to the existence of regulated and registered employment contracts. Any long-term promise is meaningless if workers (or employers) cannot enforce it in later periods when conditions change. As countries move toward higher levels of enforcement, they should therefore be aware of the possible effects of increased formality on wage flexibility.

JOB-WORKER MATCHING

The labor market has persistent gaps and lags between the demand for workers by employers and the supply of jobseekers.¹¹ In a world where one in four jobs is destroyed or created in any given year, these gaps and lags have significant economic costs. Many factors explain this failure to fully clear the labor market: limited dissemination of information about job openings, mismatches between the skills workers have and the skills employers need, jobseekers with poor skills for finding appropriate employment, and discrimination, just to mention a few.

Labor policies can help to increase the efficiency of the job-worker matching process. Policies that increase the effectiveness of job searches and reduce the cost of filling vacancies help to increase employment, while their direct effect on wages is ambiguous. However, the most important effect of these policies is to increase the productivity of job-worker matches in the labor market. Labor intermediation services are intended to improve the speed and quality of the match between available jobs and jobseekers. In this way, such services intermediate between labor supply and demand. The principal clients of such services are unemployed or underemployed workers and firms seeking new employees.

There are many advantages in making the match between jobseekers and jobs faster, less costly, and of better quality. A better quality match would mean the employee would more closely fit the job, be more productive, and likely stay in the job longer. A faster and less costly match would reduce the firm's output losses, increase productivity, and reduce staff time in personnel functions. It would also increase the worker's income and reduce the social and family costs of unemployment or underemployment. Lower costs would also result for the wider community in terms of reduced need for social services and reduced unemployment insurance or social service pay-

¹¹ This section is based on Mazza (1999).

ments, if applicable. As these services increase the transparency of labor market exchange mechanisms, they also help to reduce discrimination.

Intermediation services can fulfill a number of useful functions, but they cannot create jobs. If a country is facing a true employment crisis with conditions of high structural unemployment, it is generally more productive to look for, and hopefully solve, wage rigidities that impede employment generation. The principal economic purpose of labor intermediation is to create information useful for linking demand and supply, thus increasing productivity and social welfare, not to create jobs. However, labor intermediation services may also coordinate with income support or other safety net programs, thus fulfilling a function within the safety net.

Labor intermediation services are an important tool of labor policies. A number of evaluation results for OECD countries point to the fact that job search assistance is highly cost effective in helping to put workers in new jobs.¹² New evaluations of programs in Mexico also show that some low-cost interventions (such as subsidizing transportation costs for job interviews) help shorten the duration of unemployment. However, the challenges that labor intermediation services face in the region differ from those faced by their counterparts in more developed OECD countries. On the one hand, the prevalence of unregulated forms of employment contracts (including self-employment) dictates that labor intermediation services should include services adapted to the variety of labor market insertion of their clients (such as referral to microenterprise programs). On the other hand, given the limited size and scope of existing labor intermediation services in the region, reforms should start by fostering an adequate regulatory environment for private and nonprofit providers that facilitates the development of new public-private partnerships.

Labor Intermediation Services

Around the globe, there are new efforts to innovate and reform ways to better match jobs to jobseekers. National public employment services were first created in the developed economies around 1900.

Today, many of these public employment services are being reformulated and reformed, private services are being expanded, and new partnerships are being sparked between the two. In these new policy reformulations of employment services, it is more accurate to call the emerging systems labor intermediation services because the range of services has become broader in intermediating between workers and jobs and between jobs and education and training, self-employment, and other needed social services.

Broader Range of Services

The core labor market intermediation services are job search assistance and job placement or brokering. The first encompasses actions to help the job-seeker in finding new employment through resume preparation, development of a job search strategy, occupational information, and contacts with employers. Job brokering, in turn, relies on the maintenance of a registry and information on current job openings; it seeks to match specific openings with specific applicants. This task is not as simple as it sounds because employers' job needs change rapidly. To be effective, the service must maintain a wide number of listings, keep them current, and be skilled at placing the right people in the right jobs in order to ensure that employers continue to use the service.

Research has continued to indicate that job search assistance is highly cost effective and productive as a method of assisting workers into new jobs. Positive impacts as well have been noted in job counseling, particularly with two or more sessions.¹³ Job clubs have also been shown to assist the long-term unemployed in developed countries.¹⁴

¹² See OECD (1996) for OECD countries; Fretwell, Benus, and O'Leary (1999) for transition economies in Eastern Europe; Samaniego (2002) for Latin American countries; and Dar and Tzannatos (1999) for an overall review.

¹³ A Canadian study finds that two or more sessions increased the level of job satisfaction (Government of Canada 1989).

¹⁴ A European Commission report cites the range of participants receiving work after participation in a job club from 8 percent in Ireland to 73 percent in a small pilot project in the Netherlands (Commission of the European Communities 1991).

Table 8.1 Principal Functions of Labor Intermediation Services

Service category	Target clients	Types of services
Job search and employment profiling	<ul style="list-style-type: none"> • Jobseekers 	<ul style="list-style-type: none"> • Skills testing or referrals to testing • Profiling of clients to determine services needed • Resume preparation • Job counseling • Phone banks for job search • Job search assistance • Job clubs • Case management
Job placement brokerage	<ul style="list-style-type: none"> • Employers • Jobseekers 	<ul style="list-style-type: none"> • National database of job vacancies • Job placement • Vacancy intake (firms) • Candidate screening (for firms) • Outplacement • Recruitment for select positions (firms)
Training	<ul style="list-style-type: none"> • Jobseekers • Training providers • Employers 	<ul style="list-style-type: none"> • Assessments of training needs and requirements • Referral to private and public training providers • Training directly by labor intermediation service (limited)
Specialized services for employers	<ul style="list-style-type: none"> • Employers 	<ul style="list-style-type: none"> • Human resource assessments • Legal advice on employment • Screening and testing of job applicants • Sector promoters and liaisons • Staff training guidance
Labor market information	<ul style="list-style-type: none"> • Government (local and national) • Firms • Jobseekers 	<ul style="list-style-type: none"> • Data and analysis on labor market trends
Unemployment insurance and social services; gateway to social services provision	<ul style="list-style-type: none"> • Jobseekers 	<ul style="list-style-type: none"> • Administration of unemployment insurance benefits or referrals • Referral or coordination with social services • Referral to self-employment programs

Labor intermediation services include a range of secondary services designed to improve the quality and efficiency of intermediation. These services are secondary only in that not all systems of labor intermediation offer such services. In many cases, these services can be central to the efficient functioning of the match between workers and jobs. They include employment profiling and skill assessments (that evaluate the skills required by jobs and offered by searchers to develop a better search strategy), referral to training services, development of labor market information systems, and serving as a social and business service “gateway” (intermediating between searchers and other service providers, such as self-employment or credit programs). Additional labor intermediation services regulate private

intermediation services and provide specialized services (mostly substitutes for human resource functions in firms). Table 8.1 summarizes the types of services that labor intermediation services offer.

Variety of Clients and Service Packages

The great variety of labor intermediation services reflects the fact that no one package of services fits the needs of every worker seeking employment through an intermediation service. Some workers need little assistance and others need a lot. For those job-ready clients who already have the skills and recent work history to find a new job relatively easily, low-cost resume preparation and job search orientation might be enough to get the indi-

vidual into a new position.¹⁵ Older workers with outmoded skills, workers with social difficulties that impede employment (such as alcoholism, poor work record, or poor skills), single parents who require integrated services (including child care), or indigenous or disadvantaged workers with cultural or linguistic barriers are best handled on a case management basis. Counselors could look at the complexity of their employment situation and help tailor the right combination of services and follow up closely with the many elements of a job and social services strategy. In the most likely intermediate case, a worker might be new to a field but have skills that are transferable or that could be developed through on-the-job training. In this case, services would need to include the intervention of a job counselor, referral to short-term training programs, development of a job search plan that includes identification of a range of positions in the vacancy database, direct solicitation of firms, and case follow-up.

Categories of employer clients have not been as easily classified. Typically, a labor intermediation service would distinguish between a set of basic services provided to all employers, including the critical service of registering job vacancies, and a set of enhanced services that would be provided on a fee-for-service basis to firms on request.

In assessing how to structure the services to be offered to each client, national intermediation services reflect different national philosophies about the nature of public service. As a matter of policy, in a number of European countries (for example, Austria and France), all services are offered to all clients, that is, services are universally offered. In other nations, services are not offered universally, but selectively, based on a personal or formula-based determination of which beneficiaries need the services the most (for example, Great Britain and the United States).¹⁶

Institutional Structure and National Public Service

Labor intermediation services have historically been seen as a monopoly public service. During the early post-World War II period, labor interme-

diation services in many OECD countries were a single, national public service run by the ministry of labor. The basic operational philosophy was reflected in the relevant International Labour Organization (ILO) conventions, which created a public monopoly of intermediation services.¹⁷ Private employment agencies were seen as potentially exploiting workers by charging for placement, delivering poor quality service, and “creaming” the best candidates, relegating public services to the most difficult cases. Recently, however, the ILO has enacted new conventions that reverse the ban on private employment agencies and call for enhanced oversight and regulation.¹⁸

This regulatory development arises from experimentation by OECD countries to test new methods of making labor intermediation systems more effective, looking at how to reach a greater number of workers and firms in a more client-driven fashion. The new conventions take advantage of new technologies and demand more explicit and definable outcomes. These efforts are not just oriented to reform old public employment services, but modernize and design the larger system of public and private services. First, the reforms make public employment services more efficient, effective, and client-driven, introducing a number of pri-

¹⁵ In a number of countries, such clients would be candidates for self-service services, that is, they could be left on their own to navigate the system’s job database and resource library, asking for assistance only when needed.

¹⁶ The United States has moved the farthest to an automated, formula-based assessment of which clients are most at risk for long-term unemployment and thus eligible for a wider range of services earlier. Those defined most at risk are eligible for social services and training. The profiling system utilizes a number of characteristics of the client—including age, length of time in previous employment, and occupation—to assess the potential for long-term unemployment. The system does not use characteristics such as race and ethnicity. This computer-based profiling system is relatively recent and there is widespread agreement that it is still “getting rid of teething problems” (OECD 1999, p. 195).

¹⁷ The basic ILO Employment Service Convention (1948) establishes that placement services should be guaranteed free of charge to workers. The accompanying 1949 Fee-Charging Employment Agencies Convention bans private agencies that charge fees for placement of workers, effectively creating a public monopoly.

¹⁸ In particular, the 1997 C181 Private Employment Agencies Convention and R188 Private Employment Agencies Recommendation, 1997.

vate sector practices.¹⁹ Second, the services expand the use of private labor intermediation services, either as contractors to public systems, competitors, or partners in a national labor intermediation system.

Labor Intermediation in the Region

Recent reform and modernization of labor intermediation systems in Latin America and the Caribbean have had a distinctly different point of departure than reforms in OECD countries. In particular, the following characteristics of Latin American and Caribbean systems contrast with those of the OECD:

- Typically, Latin American national employment services are less extensive and have a lower investment level than their OECD counterparts.
- Private sector placement and employment services are generally less prevalent in Latin America and the few existing firms are newer. Some national employment services have a reputation of being politicized by local and regional authorities, thus discouraging the private sector from working more directly with these offices.
- The majority of Latin American countries do not have unemployment insurance, and so reform of labor intermediation services does not address the integration of such systems. As a consequence, potential cost savings in unemployment insurance is not a motivation for reform of the national labor intermediation service. Those countries in the region that do have unemployment insurance do not typically use a national employment service to administer unemployment insurance (for example, Argentina and Brazil).
- Discriminatory markets—lack of transparency, misinformation, and discrimination—are particular motivations for strengthening labor intermediation service systems in Latin America and the Caribbean. The region has a high reliance on informal networks and family/personal contacts, and this is typically viewed as reinforcing and perpetuating discrimination based on race, ethnic origin, gender, and economic class.
- Unregulated, precarious employment can exceed 50 percent of the national economy, with a

concentration of poor and disadvantaged workers in these contracts. By definition, this shapes a different approach to labor intermediation designed to serve the regulated sector of the labor market.

- Latin American countries have less of a chronic problem of long-term unemployment in the workforce than a problem of low education and work skills.
- There is substantial internal and external migration in a number of countries, particularly within Central America and Mexico.

Currently in Latin America there are a number of public national employment services and a limited but growing private sector market in labor intermediation and placement. However, in the majority of countries in the region, there is a small public sector service that, with limited resources, typically serves the lower strata of the workforce.²⁰ National employment services in the region are typically administered by either the ministry of labor or the state-based national training institute (for example, SENA in Colombia). Latin American and Caribbean systems typically concentrate on the core functions of job brokering and job search.

The traditional target of labor intermediation services in the region has always been formal sector jobs, which have employers that more openly advertise and solicit employees. In countries that have an extensive unregulated sector and a high proportion of self-employed workers, there are clear benefits to improving the match of workers to jobs; however, special consideration needs to be given to the labor market placement of some types of workers. Labor intermediation services should include matching and referrals to programs in microenterprise, self-employment, and small busi-

¹⁹ Key reforms pursued within the OECD countries include (1) integrating core functions, (2) expanding policy interventions for the long-term unemployed, (3) introducing and strengthening performance indicators, and (4) introducing market signals in the operation of public employment services.

²⁰ The directors of the public employment services of Central America, for example, stated that, historically, intermediation services in the region have been occupied with the strata with “low technical qualifications at the lowest levels of the occupational pyramid” (ILO 1998).

ness development, which are frequent (and sometimes the only) sources of employment for portions of the labor force, particularly older workers.²¹ In most countries in the region, self-employment programs are provided by a range of providers, such as governments and nongovernmental organizations (NGOs), but rarely on a walk-in demand basis. Few clearinghouses provide information on a range of alternative programs and help candidates assess the best fit for their needs. Labor intermediation systems in the region should also consider whether intermediation centers can provide advice, information, and referrals on the formalization of businesses.

A word of caution is needed here. As in developed countries, countries in the region should clearly avoid putting labor intermediation services in a regulatory role that discourages participation in the service. It is useful to provide information on a voluntary basis in some cases, particularly if the government is offering expedited procedures to register businesses.

Many Latin American and Caribbean countries face major labor market challenges in the concentration of low skills, poor education, poverty, and labor market discrimination (employment and wage discrimination) among specific populations, especially women, ethnic/racial minorities, youth, and the handicapped. Among the greatest concerns in the evolution of labor market intermediation systems is how to more effectively reach these target populations. To provide for the social inclusion of these groups in the marketplace, labor intermediation services must be careful that the public/private market does not become so segmented that the national public service receives only the most disadvantaged clients. This would lead to increasing disuse by private employers. The challenge is in increasing the coverage of disadvantaged groups while simultaneously expanding the overall client and employer base in order to provide more opportunities to refer disadvantaged groups to better quality jobs.

For many of the poorer countries in the region, out-migration of labor—both legal and illegal—to higher-income countries has continued for several decades. Migration trends are increasing

even within the region; for example, Nicaraguans work in Costa Rica and Peruvians work in Chile and Argentina. This migration can be seasonal, temporary, or permanent. For countries such as the Dominican Republic and El Salvador, worker remittances from abroad are a major source of national income and substantially affect the operation of the local labor market. For higher-income Caribbean countries, there is a reduction in job opportunities in the low season. A key question and controversy is whether a national labor intermediation service should play a role in regularizing temporary or seasonal migration or protecting or overseeing workers migrating within the region. Some countries in the region follow ILO conventions and guidelines in prohibiting private employment agencies from facilitating and charging for overseas placements. Other countries allow private agencies to play a role with the justification that this provides workers a legal and safe path for migration and safe return to their home country.²²

Reforming Labor Intermediation Services

Reforming existing intermediation services requires fostering an appropriate regulatory environment for private nonprofit providers, a condition for creating new public-private partnerships. Staff of the labor intermediation services should be trained and information and performance-based systems introduced to measure the efficiency and effectiveness

²¹ Ivan Gonçalves Ribeiro Guimarães, who runs the state employment service in Brasília, Brazil, for example, says that workers over age 33 who have lost their formal sector jobs are particularly difficult to place. Statistics show that only about 2-3 percent of the unemployed in this age group find employment in the formal sector (interview with Ivan Gonçalves Ribeiro Guimarães, Brasília, 14 May 1998).

²² Mexico, for example, has a specific arrangement between its public employment service and the Canadian government in which the service screens a set of agricultural workers who are provided legal visas and travel costs to work seasonally in Canada. The National Employment Bureau of Barbados lists seasonal overseas job opportunities under special programs largely in Canada and on U.S. cruise ships. The directors of the Central American employment services, for example, maintain the importance of continuing to meet on a regional basis to share national experience, propose adequate national policies, and seek ways to guarantee better conditions for migrating workers, actions which have implications for employment services (ILO 1999).

of the services. After these initial steps, there should be a more ambitious overhaul of the institutional framework and the roles of the private and public sectors. However, investment in information systems and development of a training registry and referral systems are critical investments at this stage to enhance the attractiveness of the services to employers and jobseekers.

Recent experimentation in the region has shown that three areas are promising for increasing the efficiency and cost effectiveness of labor intermediation services: (1) introducing and expanding information systems, (2) fostering partnerships with the private and nonprofit sectors, and (3) improving performance and expanding the client base.

Information and Internet Systems

Throughout the region, there is a clear trend toward putting new technologies to work in improving the performance of labor intermediation systems. Large investments in new information system technologies for intermediation systems have been more limited in Latin America and the Caribbean than in the OECD, but countries and local municipalities are beginning to invest in new computer-based systems.

Chile's Servicio Nacional de Capacitación y Empleo has developed the country's first electronic labor exchange. InfoEmpleo currently contains more than 29,000 resumes of jobseekers and receives more than 300 job vacancies a month.²³ Mexico has also made important advances and investments in information systems for its network of employment services, and has developed ChambaNet and ChambaTel, two innovative labor exchange programs that connect jobseekers directly to existing vacancies. Costa Rica, under financing and support from the National Apprenticeship Institute (INA) is developing a two-phase information system to revitalize its public employment service, expand to a network of private and nonprofit providers, and provide a national job registry with INA providing the central server.

Another important development in the region is the use of electronic *bolsas de trabajo*, not just on

a single country basis, but also as part of a regional network. Under its program to modernize the labor ministries of Central America, Belize, Panama, and the Dominican Republic, the ILO is examining electronic job exchanges on a regional basis.²⁴ Under a regional project of the IDB Multilateral Investment Fund, eight countries—Central America, the Dominican Republic, and Panama—have developed a labor market information system in which labor market data can be jointly shared and analyzed on a regional basis, including data on employment, economic, and occupational trends.

Private and Nonprofit Services

Another emerging trend in the region is the expansion of the role of private employment agencies and initiatives to create partnerships between public, private, and nonprofit providers. Argentina is seeking to better link its public employment offices with the nonprofit and private employment agencies operating in the country. Peru created a network of public, private, and nonprofit providers, significantly increasing the reach of the system (Ministry of Labor and Social Security 2001). Guatemala is developing plans to create a network of employment services (Red de Servicios de Empleo) in which the local public office of the national employment service in each region or province would serve as a center for a local network that would include private and nonprofit providers. The pilot program of the network would begin in the metropolitan area of Guatemala City. As a first stage in opening up and regularizing a private sector market, a number of countries in the region are working to provide appropriate legal frameworks and institute regulations or oversight of private providers. For example, Panama passed a law in August 1995 permitting for-profit employment agencies and providing for the ministry of labor to have oversight over such agencies.

²³ <http://www.sence.cl/>.

²⁴ <http://ns.oit.or.cr/matac>.

Performance, Output, and Client Base

Countries in Latin America and the Caribbean are undertaking a series of actions to improve the performance, output, and client base of their systems. First, they are using job fairs as temporary one-stop centers. These *ferias de empleo* do more than just bring employers and jobseekers together face-to-face for one day. Job fairs, like those in Panama, are expanding to offer a range of services more akin to the type of one-day, one-stop shop that operates in OECD countries. Services available at the Panamanian job fairs include technical assistance for microenterprise, career information, resume workshops, information on training programs and needs, and assessments of jobseekers' work skills in addition to interviews with employers. In the Panamanian case, these fairs are self-financing, that is, they are fully paid for from the fees charged to employers establishing booths at the fairs. Mexico also has a comprehensive approach to job fairs, which serve as a hub for the national and local employment services to interact with private sector employer organizations.

Second, there is a more limited trend in the region toward decentralization of labor intermediation services to local municipalities and offices. The role and feasibility of decentralization in any country depends on a larger national strategy and trend toward decentralization and on the capacity of local institutions, particularly in relation to the variety in quality of service that can result without sufficient local capacity. For example, Chile has decentralized local employment offices to a network of more than 150 municipal employment agencies. These offices provide mediation services free of charge to workers. The Chilean National Training and Employment Service provides technical support to the network, plans and supervises training programs and institutions, and monitors the performance of the tax rebate plan for enterprise-based training (Martínez Espinoza 1998).

Third, systems in the region are working to improve the services that intermediation centers provide, for example, job search methodologies and assessments. Improvements include sharing information and tools across the region and providing information at international forums.

THE RISKS OF JOB CHURNING

The high level of macroeconomic volatility of Latin American economies, which is documented in chapter 4, has generated a strong social demand for mechanisms to protect the working population from the resulting risk of income loss. Traditionally, this demand has been met by the enactment of employment security regulations that penalize terminations either through high severance payments when terminations are allowed, or through direct prohibition of terminations. The region had high levels of employment protection until the mid-1990s, even relative to the protection enjoyed by workers in more developed OECD countries (Márquez 1997; IDB 1997; and chapter 7, this volume). For workers with regulated contracts, severance payments are quite high and employment protection regulations are strictly enforced both in practice and in the courts.

In a sense, employment protection works as privately implemented unemployment insurance with coverage limited to those workers with a regulated employment contract. These workers are protected both because the firm has a positive cost associated with termination (ensuring that layoffs and firings will be used sparsely as adjustment mechanisms), and because unemployed workers receive an income transfer through severance payments.

However, in most countries in the region, unregulated, precarious employment relations and self-employment account for more than 50 percent of the workforce. In a sense, the absence of job security for these segments of the population has provided wage flexibility, which has characterized the region until recently. However, as discussed in chapter 4, things are changing and the reduction in inflation and increasing demands for improvements in institutional quality (including rule of law in the labor market) are eroding the margins of wage flexibility and increasing the unemployment costs of downturns.

For workers who are not protected by labor market regulations and do not benefit from the protection of severance payments, the increasing unemployment risk is a serious threat. If countries

are to protect the majority of their populations in the context of a broad social compact, more forms of social insurance are required. Labor policies can help workers cope with the risks of job churning and reduce the associated income loss before it drags entire families into poverty. In a world where 25 percent of the existing jobs are created or destroyed in any given year, how to insure against the cost of job loss is not a minor question.

A caveat is in order. It could be argued that many workers in regulated labor contracts are overinsured through severance payments. If a worker receives six months of current wages on firing and the average unemployment duration is three months, this worker is indeed overinsured. This overinsurance raises labor costs and therefore reduces employment (see chapter 7). The policy remedy is to substitute insurance mechanisms for incumbents, not to pile up additional insurance. The point is to move away from forms of proto-insurance and making individual severance payments in two directions.²⁵ Regulatory change and enhancement of the social protection network are essential tools for this task.

Regulatory change should seek to move away from severance payments and toward unemployment insurance for workers who have regulated labor contracts. Of course, this is easier said than done because such a change would have to overcome the political opposition of the labor movement. And its effectiveness would be conditional on significant organizational and institutional changes (including creation of individual savings accounts in the pension system). (This is discussed more fully below in the section on unemployment insurance.)

Financial and human resources should be invested in the maintenance (and in some cases establishment) of an effective network of institutions and policies to protect workers who have precarious labor contracts or are self-employed. Given the concerns about economic insecurity reflected in surveys such as Latinobarometer, sustaining political support for the modernization process will require the development of a broader social contract explicitly designed to operate in the context of more competitive, open, and therefore more vul-

nerable economies (Birdsall 2002; Graham 2002). Social insurance policies are a crucial piece of this new social contract, and their failure in the past decade helps explain many of the political difficulties faced by governments that are willing to deepen the modernization process. At the same time, experience shows that when income support policies are implemented in a transparent way and with efficient coordination between local and national authorities, they are effective in countering the negative effects of adverse external shocks (Ademar, Tergeist, and Torres 2000).

There is no single recipe for the design of social insurance. The unhappy equilibrium in the labor markets of many countries in the region today is the accumulated response to aggregate sector and idiosyncratic shocks. Each country has faced particular shocks and, even when reacting to aggregate regional shocks such as the Tequila or the East Asian crisis, each country has adjusted differently, and groups of workers have faced varying consequences. Even if countries faced a set of common labor market problems, policies in each country must take into account the nature of the adjustment of each economy. There is no one-size-fits-all policy; countries need to use different sets of policy instruments to help workers cope with income losses associated with job relocation.²⁶

A common trait that requires attention is the number of workers that do not have legal employment contracts with benefits, but that are self-employed or working in casual, unregulated situations. This creates particular problems for the design of policies above and beyond the obvious problem of noncompliance with regulation of benefits and working conditions. New and innovative methods of collaboration between the public and private sectors are needed to provide social insurance for workers in these activities. Experience

²⁵ Blanchard (2002) refers to severance payments in a world with perfect information and different risk preferences of workers and firms as "proto-insurance."

²⁶ The flip side of this affirmation is that countries will need to invest in the development of labor policy institutions that collect, analyze, and process information, and that implement policies and enforce regulations.

indicates that this will require mainstreaming the informal sector into the institutions that govern market transactions, commercial contracts, and industrial labor relations. Mechanisms should be developed to provide social insurance tailored to the particular characteristics of work in the informal sector (Chen, Jhabvala, and Lund 2002).

The Toolbox

Tools for building a social insurance system originated in the efforts of the region's governments to cope with the crises of the 1990s and the renewed volatility in international capital markets. These efforts have created an opportunity to test some new ideas and disseminate innovative approaches to old problems. Labor-intensive public works programs, youth training programs, and semi-universal unemployment insurance systems all have become acceptable ideas to help sustain the incomes of affected workers. These programs developed historically as a response to the urgency of coping with the effects of crises. As such, the quest for mechanisms that could be set up quickly to transfer income to the poor in the most targeted way possible dominated optimal design considerations. By design, the expenditure in these programs should have been countercyclical; in practice, it was not, given the size of fiscal adjustments that had to be undertaken (Braun and di Gresia 2003).

The region's experience with income support programs shows that they can at least to some extent help compensate for the effects of economy-wide shocks on workers. A varied array of programs has been used to help workers cope with one or another of the damaging effects of these shocks. This battery of programs will be the backbone of any social insurance system, given organizational, political, and resource constraints that limit the ability of the government to create new programs.

However, social insurance mechanisms have different content and clientele compared with the safety nets of the 1990s. Although the rationale of safety nets is to protect the human capital of the poor during economic downturns, the objective of social insurance mechanisms is to help all workers (not just the poor) cope with the consequences of

the job creation and destruction that characterize modern economies. For this reason, social and labor market policies require a higher dose of social insurance vis-à-vis poverty alleviation programs than what governments adopted and international financial institutions recommended during the 1990s. Unfortunately, social insurance mechanisms, such as unemployment benefits and other programs that provide income support, are less developed in Latin America than in OECD countries (Bourguignon 2000).

The mechanisms of social insurance should aim at providing a minimum income guarantee to the largest number of workers possible. To be feasible in financial and economic terms, they need to fulfill at least three requirements:

- Their design should minimize labor market distortions and, in particular, should not create incentives that result in reduced employment or output.
- Their coverage should be as wide as possible, given that the risk of unemployment affects all workers, including those in unregulated and precarious forms of employment contracts.
- Their budget allocation should be adjusted countercyclically, expanding in economic downturns when unemployment increases, and contracting in expansions when it decreases.

Coverage of unemployment insurance will not be wide enough to protect all workers, particularly the poorer ones. Part of what differentiates the poor from the nonpoor is the nature of their labor market insertion and, therefore, the mechanisms that need to be devised to insure them against the risk of income loss. Poor, low-productivity workers must rely on alternative mechanisms for protection because they cannot afford the cost of unemployment insurance, or they are in employment situations (self-employment or casual work with unregulated contracts) that make it unsuitable as an insurance mechanism. For these workers, a menu of alternatives needs to be provided based on the existing mechanisms of income support.

Table 8.2 presents a general vision of a social insurance system. At the center of the scheme, a

Table 8.2 The Design of a Social Insurance System

Program	Targeting	Financing	Institutional requirements
Unemployment insurance	Nontargeted, covering all workers in regulated contracts (in lieu of severance payments)	Financed from workers' and firms' contributions	Independent financial institution(s) System connected to pension system
Scholarships for short-term classroom training, apprenticeships, and job search assistance	Unemployed youth	Financed from training system payroll tax	Opening of the market for training services; network of nongovernmental providers
Employment generation programs Labor-intensive public works	Self-targeting	Financed from general revenues, strongly countercyclical	A solid network of local institutions able to apply selection criteria and develop works
Wage subsidies	Administrative	Exemption of payroll taxes, financed from general revenues	Sophisticated enforcement and verification system from labor authority
Cash transfers	Very narrow, based on family income below the poverty line	Financed from general revenues	Sophisticated targeting system

well-designed unemployment insurance system covers the group of workers that, given their employment contracts and productivity, can buy the insurance. Workers who are not clients of the unemployment insurance system can be referred to either a short-term training program or an employment generation scheme. For workers who exhaust their benefits in the system, cash transfer programs can provide limited income support.

Unemployment Insurance

Table 8.3 presents a summary description of unemployment insurance systems in the region. Few of the countries have legally and/or administratively enacted unemployment insurance systems, and even fewer have working unemployment insurance schemes. This is a consequence of the weak incentives for the development of unemployment insurance and other more socialized forms of income protection, given the fact that severance payments work as privately provided income insurance for workers in full-benefit employment contracts.

In those countries that do have unemployment insurance systems, coverage is limited to workers that have contributed while employed to the financing of the system. In other words, only workers in full-benefit employment contracts and working in firms that pay payroll taxes enjoy the benefits of the unemployment insurance system. The level and duration of benefits provided are low relative to the unemployment insurance systems in more developed countries. Replacement rates are normally on the order of 50-60 percent of the most recent wage, with the maximum linked to the minimum wage for higher salaries. Typically, benefits are granted for no longer than four months.

The unemployment insurance system in Argentina, for example, has a limited number of beneficiaries in spite of strong increases in the number of unemployed workers. Mazza (1999) reports that the number of beneficiaries has remained stable at between 100,000 and 125,000 workers, of which more than 70 percent are prime-age males and more than 50 percent are not household heads. Mazza also reports that an analysis of beneficiaries' personal and previous job character-

Table 8.3 Unemployment Insurance in Latin America and the Caribbean

Country	Law	Funding	Replacement rates ^a	Benefit duration	Benefits min./max.	Coverage	Requirements ^b
Argentina	1991 (reform in 1995)	Worker: 1 percent of wages Employer: 1.5 percent of payroll	60 percent	4–12 months	Min: minimum wage Max: 4 times the minimum wage	Employees	1 (12), 2, 3
Barbados	1982	Worker: 1.5 percent of wages Employer: 1.5 percent of payroll	60 percent, 10 weeks 40 percent, 16 weeks	26 weeks in a 52-week period		Employees age 16–64	1 (6)
Brazil	1986 1990	FAT ^c (0.65 percent tax on total sales)	1–3 times the minimum wage	4 months	Min: minimum wage	Employees	4 (36, 4), 5, 6
Chile	2001	Worker: 0.6 percent Employer: 1.6 percent, plus employer (0.8 percent of payroll) and state fixed contribution to solidarity fund	Amount is a function of accumulation in individual account; maximum of five payments from solidarity fund	1 payment per year of contribution to the unemployment insurance fund	Minimum from solidarity fund 30 percent of the last wage or \$41–89 Maximum 50 percent or \$103–171	Employees starting new contract, voluntary affiliation on existing contracts	2, 9
Ecuador	1958, 1988	Worker: 2 percent of salary Employer: 1 percent of payroll	One-time subsidy, amount decided each year			Employees	1 (24), 7
Mexico		Social security	95 percent of pension	5 years maximum		Employees age 60–65	Age 60–65
Uruguay	1981	Contributions to social security	Up to 50 percent	6 months	Min: 50 percent of minimum wage Max: 4 times the minimum wage	Employees in commerce and industry	1 (6), 5, 3, 8
Venezuela	1989 (reform in 1999)	Worker: 0.7 percent of wages Employer: 1.5 percent of payroll	Up to 60 percent	13–26 weeks	Max: \$44	Employees	1 (12), 2

^a Percentage of last wage.

^b Beneficiaries also receive family support and medical and maternity benefits.

^c Fondo de Amparo ao Trabalhador.

Requirements are as follows:

1 (s) – Employed s months before receiving subsidy.

2 – Availability to work.

3 – Does not receive other social security benefits.

4 (s, j) – Not having received more than s months of benefits in the past j years.

5 – Unemployed for reasons outside the conduct and willingness of the worker.

6 – Subject to economic need.

7 – Waiting period.

8 – At least 12 months between periods of receiving subsidy.

9 – Subject to availability of funds in individual account.

Source: Lora and Pagés (1997); U.S. Department of Health and Human Services; Acevedo (2003).

istics shows that there is a definite trend toward serving younger and middle-class displaced workers. This suggests that unemployment insurance is not fulfilling a safety net role for the poor in the case of Argentina.

Until it was surpassed by Chile, Brazil had the largest unemployment insurance system in the region, with 300,000 to 400,000 beneficiaries. Mazza (1999) reports that unemployment insurance in Brazil also serves younger (more than 50 percent of beneficiaries are younger than 30 years old) and more educated (45 percent of beneficiaries have completed eighth grade or better) workers.

In 2001, Chile enacted a new law implementing an unemployment insurance system, which began operations in October 2002. The Chilean system is based on a defined contributions/variable benefits regime. Workers and employers contribute to nominative individual accounts, and contributing workers are entitled to one monthly payment for each 12 months of contributions to the unemployment insurance fund, the amount of the payment being a function of accumulated funds. A solidarity fund, funded by employers and the treasury, pays benefits to workers with insufficient funds in their individual accounts. Affiliation is mandatory for workers in new labor contracts and voluntary for workers already in jobs. By March 2003, voluntary affiliation was much larger than expected, and the system is already covering more than 900,000 workers, or around 30 percent of potential affiliates. Following the general pattern in the region, the share of workers affiliated with the unemployment insurance system grows with the education level.²⁷

In Venezuela, the unemployment insurance system was enacted in 1989, but was never implemented. The system was reformed in 1999, but again never implemented. The new system would protect beneficiaries through a mix of individual and collective insurance operated by competitive insurance providers. Given that only workers with regulated, tax-paying contracts are entitled to benefits, it is likely that the distribution pattern of beneficiaries would be similar to that in Argentina and Brazil.

Mexico and Uruguay have unemployment insurance programs operated by the social security

system. In both cases, coverage is limited. In Mexico, coverage is just an advance payment of the old-age pension for a maximum period of five years. In the case of Barbados, the unemployment insurance system is comparatively generous, although quite well adapted to the needs of an island economy with frequent but short episodes of unemployment concentrated among workers in the tourism industry (Mazza 1999).²⁸

Differences in design, coverage, and benefits make it difficult to present an overall assessment of the importance of unemployment insurance systems as part of a comprehensive social insurance mechanism; however, there are some common traits. First, unemployment insurance is normally a benefit in addition to the severance payment. The worker has the right to unemployment insurance as a supplementary source of income during the search for a new job. Therefore, income protection by the unemployment insurance system is targeted to workers that have had full-benefit employment contracts. This excludes from protection a sizable fraction of the workforce in the unregulated segment of the labor market, presumably those who are the most needy in terms of income protection.

Second, unemployment insurance systems generally lack connection with other labor market intermediation and placement services. Even in cases where the unemployment insurance system is operated through the labor ministry (as in Brazil), workers are not required to register with the intermediation service, and payment of the benefit is not contingent on verification of search effort. On the one hand, this lack of connection generates an opportunity for fraud. Even if it is illegal to have a job and receive unemployment insurance payments simultaneously, most operators complain of their lack of capacity to control what is perceived to be widespread fraud and collusion

²⁷ *Notas del Seguro de Cesantía*, año 1, no. 1, March 2003.

²⁸ Mazza (1999) notes that Barbados is the only example where severance payments were capped and eligibility limited when unemployment insurance came into being in 1967.

between firms and workers.²⁹ On the other hand, this lack of connection with labor market intermediation services makes the system a pure income transfer that does not ease the transition of the unemployed into a new job.

Third, most unemployment insurance systems are financed through payroll taxes, which are already high in the region. This partly explains the limited coverage, low replacement rates, and short periods of coverage. Any expansion of the system to cover hitherto unprotected segments of the population would likely face substantial opposition by the present beneficiaries and by firms operating in the regulated sector of the economy. However, in the case of Brazil, some expansion to new groups has been made (to traditional fishermen and workers affected by the drought in the northeast), but the expansion has been temporary and financed through the use of excess funds. If unemployment insurance were to work as part of the safety net in a crisis, the expansion of coverage would have to be produced just when the flow of benefits to already protected workers was highest, creating financial strains on the system and the need for additional funding. The question is whether this effort should go through the unemployment insurance system or through an alternative mechanism for income transfer that would be better suited to the needs of various groups of workers.

The design and target population of unemployment insurance make it suitable for protecting workers who have full-benefit employment contracts and that acquire rights to it through their contributions while employed. In terms of labor market distortions, the low level of benefits and their short duration apparently do not create an incentive against job search. In fact, reports of fraud in Argentina and Brazil suggest that workers use unemployment insurance as a means to obtain additional income while in a new job. As Hopenhayn and Nicolini (2001) show, it is possible to design optimal unemployment insurance schedules that do not induce reduction in search efforts. Furthermore, schemes of unemployment insurance based on nominative contributions to individual accounts that can be rolled over into retirement funds can minimize the negative impacts on search effort.³⁰

In order to expand and contract countercyclically, unemployment insurance needs to be protected by transparent and well-enforced regulations. Under constant eligibility and benefit conditions, outlays increase when unemployment is rising and contract with the recuperation of employment. However, eligibility and benefits are seldom constant and those changes are expected. In the United States, for instance, the length of benefits is routinely increased during downturns. The political and institutional capability to manage this kind of decision in a fair and transparent way is thus a necessary condition for this variability to work.

There are two problematic aspects of unemployment insurance. The first is related to its employment effect. If the unemployment insurance system were well implemented, it would increase both the duration and level of unemployment via the incentive to extend the job search. This employment effect would be amplified by the indirect effect of unemployment insurance on labor costs; the larger the costs, the less inclined workers would be to accept lower wages in exchange for the additional insurance. Therefore, every effort should be made to ensure that labor costs are not affected by simultaneously enacting offsetting reductions in other components of labor costs (such as severance payments).

The second problematic aspect is related to coverage. For high-productivity workers, wages are high enough to make the benefits of paying for unemployment insurance (the expected value of benefits when unemployed) higher than the current income foregone by paying the contribution. However, for low-productivity workers, the utility gain from an increase in current income could be large enough to generate incentives to negotiate

²⁹ Mazza (1999) reports that some efforts have been made in Argentina to detect whether workers receiving unemployment insurance were working by using a common taxpayer identification number. It was found that a sizable number of workers were not only working, but also contributing to social security in a new job while continuing to receive unemployment insurance payments.

³⁰ For a proposal of an unemployment insurance system along these lines, see Cortazar and others (1995).

Table 8.4 Employment Generation Programs in the Region

Country	Beneficiaries		Expenditure	
	Thousands of workers	Percentage of total labor force	Millions of U.S. dollars	Percentage of GDP
Argentina	892.2	9.31	249.2	0.09
Brazil	221.8	0.49	1,188.8	0.21
Chile	4.3	0.10	1.4	0.00
Costa Rica	8.1	0.71	3.3	0.04
Jamaica	6.0	0.61	21.2	0.50
Mexico	1,024.0	4.42	1,802.0	0.51
Peru	27.8	0.93	100.0	0.19

Source: Based on data in Verdera (1998).

with employers a contract without benefits in exchange for higher current income.

Employment Generation Programs

Employment generation programs are a natural government reaction to increasing unemployment. Politically they show the concern of the government with the workers' plight and, by providing jobs, they directly attack unemployment. For analytical purposes, it is convenient to separate labor-intensive public works from wage subsidies to the private sector.

Table 8.4 presents a summary description of employment generation programs in seven countries in the region at the end of 1995: Argentina, Brazil, Chile, Costa Rica, Jamaica, Mexico, and Peru. These countries represent a wide spectrum of variation in terms of policy development, operational capabilities, and exposure to international capital market volatility. Verdera (1998) summarizes the program descriptions and characteristics and provides a more thorough discussion.

Argentina had the most varied set of employment generation programs, comprising a combination of public works and subsidies to private employment. The federal government also financed labor-intensive public works as an employment generation device. Trabajar and similar programs were financed and supervised by the

federal government using the Fondo Nacional de Empleo (a fund financed through payroll taxes). The resources were used to build small-scale and labor-intensive public works (in many cases social infrastructure, but also roads and small sanitation works) executed by a wide variety of agencies, including local and state governments and NGOs.

By contrast, the PROGER program in Brazil operates through the establishment of credit lines offered through the national development banking system to small enterprises, cooperatives, NGOs, and other civil society associations. This mechanism serves to circumvent subnational governments for works execution in order to avoid the creation of budgetary entitlements. However, evaluations of PROGER are not optimistic about the results in terms of employment generation (Government of Brazil 1998).

By 1995, Chile did not have an employment generation program as such, although it had a number of small and narrowly targeted programs to address living conditions that might hinder the labor market insertion of particular groups. However, at the end of the 1990s, a number of incentives and programs were introduced to reduce the cost of the rising unemployment rate.

Costa Rica uses public works, wage subsidies, and credit to small enterprises as mechanisms to promote employment generation. Credit to promote employment generation in small firms is also

widely used in Jamaica in a battery of programs, some of which also include a form of short-term training. Jamaica has a training and temporary employment program for unemployed youth, which is aimed at easing their labor market insertion.

Mexico uses public works (rural roads and other social infrastructure) as employment generation devices. The programs are financed by allocations from general revenues (not from payroll taxes) in the federal government budget, and states and local governments execute the works.

Finally, Peru uses legal incentives, a social investment fund, and a micro and small enterprise credit program as tools for employment promotion. The labor law reform of 1991 introduced a number of more precarious forms of employment contracts, allowing firms to hire workers without generating rights to severance payments under fixed-term contracts. FONCODES, a social investment fund, is also used as an employment generation device that can be quickly adjusted to the situation of local labor markets. However, it is not clear how much capacity or interest the management of FONCODES has in employment generation as opposed to the physical execution of civil works (Verdera 1998).

Labor-intensive public works. Labor-intensive public works have been the tool of choice for dealing with economywide shocks. The number and variety of programs in place in the region show that governments choose to spend more resources on employment generation than on other mechanisms for providing income support to unemployed workers. One of the main advantages of these programs is that they are self-targeted and, therefore, can be implemented without the delays necessary for implementing a targeting mechanism (Grosh 1994; Ravallion 1998).

Three characteristics of labor-intensive public works are crucial in their success as income support mechanisms. First, these programs are financed by the central government and executed by local organizations (local governments or NGOs), which normally are in charge of selecting the works to be performed and the beneficiaries.

Thus, labor-intensive public works require an extensive and solid network of institutions at the local level, with the technical and operational capacity to choose the works to be done, organize the production process, and channel resources to the needy poor. A large part of the success of these programs hinges on a well-structured relationship between the central government and the executing agencies. There is no single way to design this relationship. To mention just two examples, Argentina finances works that are approved by a central government agency and executed mostly by local governments; Brazil allocates resources semi-automatically based on regional needs and subnational governments select the works. In any case, what is important is that the design of the relationship between financing and work execution be adequate for the institutional and political structure of the country. More federalist countries should respect local autonomy in work selection and allocate budgets on objective criteria; more centralized countries will be more able to select works and distribute resources at the central level while keeping responsibility for execution at the local level.

Second, the wage level and criteria for selection of beneficiaries are set at the central level, while local organizations are in charge of the selection of beneficiaries. Thus, there is a certain degree of tension between the criteria set at the central level and the local political and social reality within which the selection of beneficiaries takes place. There are multiple ways to solve or at least mitigate the consequences of this tension. Community participation is useful for overseeing that resources are not diverted through political favoritism or other forms of corruption, but there is no guarantee that the needed level of community participation will exist. A useful complement to community participation is a system of random sampling of projects and beneficiaries by the central government agency in charge of overseeing the program to check whether resources are being diverted. This implies a nontrivial investment of resources in sampling and supervision, but these resources will pay for themselves in more transparency and better targeting of beneficiaries.

Third, the virtue of self-targeting has the vice of low wages. In order to target resources on needy groups and avoid inducing distortions in local labor markets, wages in labor-intensive public works are set below the market wage of the relevant labor market. The literature on workfare in developed countries suggests that this targeting mechanism is not without costs in terms of stigmatizing workers who participate in the program (Lightman 1995), and in terms of political and social discrimination among workers by program administrators (Rose 1994). Low-income workers, in particular, may suffer from the stigma of participating in a make-work program where no skills are imparted. Graham (2002) and Grosh (1994) report similar stigmatizing effects on beneficiaries of the Chilean Programa de Empleo Temporal during the 1980s. There is no easy way out of this problem, short of raising wages to market levels, which in most cases would be impossible, given resource constraints.

In summary, labor-intensive public works do not generate important labor market distortions to the extent that they offer wages below the relevant market and can provide a source of income for temporarily unemployed workers. Coverage depends on the amount of resources allocated to the program, but there is no intrinsic reason why coverage of low-skill workers could not be as ample as needed to reduce unemployment to the target level. This same property, however, raises the problem that labor-intensive public works are countercyclical. Because the amount of resources dedicated to the program is a political decision, there is no way of guaranteeing that the program will move in sync with the economic cycle, expanding in downturns and shrinking in upturns. In fact, experience in the region shows that once the programs are in place, it is very difficult to reduce their size.

Wage subsidies. Subsidized private sector jobs are much less widespread than labor-intensive public works programs. Argentina is the only case where wage subsidies were widely used, and even there the scope of these programs has shrunk recently due to criticisms from the union movement.

Wage subsidies work through reducing the payroll tax and/or severance payments in employ-

ment contracts for particular groups of workers (such as youth, women, or ex-combatants). This characteristic makes them suitable for the introduction of more flexible (or precarious) employment contracts in a process of reform of labor market regulation. In fact, this was the role these programs fulfilled in Argentina in 1995. But at the same time, this makes them the center of a political debate on labor market flexibility, which in large measure explains why these programs were phased out in 1998.

However, because they target particular groups, wage subsidies change the relative prices of different types of workers in favor of the target group and induce large labor market distortions, not the least of which is the substitution of subsidized by nonsubsidized workers.³¹ In order to mitigate this problem, there is normally an additionality requirement, by which subsidies are granted only for new net hires that expand the payroll. In turn, this requires the determination of a baseline number of employees and control of new hires. Theoretically, this is a task that the ministry of labor fulfills in the normal course of business. In practice, the ministries have little enforcement capability. This weakness makes impossible the task of determining baselines and controlling the hiring of subsidized workers, therefore making worker substitution a widespread problem. As a consequence, it is not clear whether these programs really create more jobs than those that would have been created without the subsidy.

In summary, wage subsidy programs tend to generate large labor market distortions by attempting to change the relative salaries of different types of workers. Because the programs have to be explicitly targeted by design, they require a comprehensive and often nonexistent enforcement apparatus, making the problem of targeting the program an intractable one. However, even in OECD countries with sophisticated recording and enforcement sys-

³¹ More formally, deadweight effects appear when the subsidized jobs would have been created anyway without the subsidy, while substitution effects appear when subsidized workers replace non-subsidized workers (Calmfors 1994). The additionality requirement addresses the deadweight effect, while substitution effects are only prevented at the margin.

Table 8.5 Training Programs in the Region

Country	Beneficiaries		Expenditure	
	Thousands of workers	Percentage of total labor force	Millions of U.S. dollars	Percentage of GDP
Argentina	133.0	1.4	95.6	0.04
Brazil	740.5	1.6	310.2	0.06
Chile	36.6	0.8	18.3	0.03
Costa Rica	13.1	1.2	60.6	0.73
Jamaica	43.5	4.4	18.6	0.44
Mexico	410.3	1.8	135.0	0.04
Peru	1.5	0.1	5.0	0.01

Source: Based on data in Verdera (1998).

tems, these subsidies are being minimized, given negative evaluation results (Martin and Grubb 2001).

The programs tend to be countercyclical, expanding and shrinking, and therefore requiring an administrative decision. To the extent that they are often perceived as a mechanism for introducing more flexible (or more precarious) employment contracts, they can become the center of political debate, making decisions about program implementation politically costly. This has been the experience in Argentina, where these programs were phased out and more far-reaching labor regulation reforms were rejected in 1998.

Training as Income Transfer Programs

Table 8.5 presents some summary statistics on the training programs used as an income transfer device in seven countries in the region at the end of 1995 (Verdera 1998). Training programs were widely used as a mechanism for transferring income, particularly to unemployed youth, through scholarships during the classroom training period (normally three to six months) and in some cases through job search assistance and/or apprenticeship stages in private firms. In most cases, the government financed these programs and private and NGO training providers delivered the programs with little or no intervention by the traditional national training institutions.

A caveat is that a common trait of this group of programs is that they use training activities, often as the result of a referral from an intermediation service. The programs are a peripheral part of the training system, which should be able to adapt countercyclically by expanding the programs while maintaining their core functions of skill training, intermediation, and education, which help lead the country to higher skill and income levels. Given the high public profile of the programs listed under this heading, they probably represent the greatest opportunity to reform the training systems.

The basic operational technology of these programs was based on Chile Joven, a pioneering youth training program that combines a scholarship for classroom training with a three-month paid apprenticeship in a private firm. Instead of direct purchasing of training services, resources are used to create a fund managed by a central government agency. The managing agency requests proposals for training projects, and funds are granted through open bidding. The proposals must describe the content of the courses to be taught and include a commitment from private sector firms to accept the trainees as apprentices for a period of time (normally three months). The provision of scholarships serves as an income transfer to beneficiaries, takes them out of the unemployment queue, and gives them some labor market experience during the apprenticeship. These three beneficial effects of the Joven program are adequately suited to situa-

tions characterized by high youth unemployment rates.³² However, other countries in the region have emulated the contracting methodology of the Joven program to cater to the needs of other population groups.

Among the countries in the study reported here, Argentina, Chile, and Peru have programs inspired by the Chile Joven design, targeting low-income unemployed youth. Argentina has also used the contracting mechanisms of the Joven program to develop training programs for other groups and granted subsidies to private employers that hire apprentices under promotional employment contracts.

Brazil uses competitive bidding for training provision, but the program operates in a highly decentralized way. The PLANFOR program is financed through the Fundo de Amparo ao Trabalhador, a fund financed by the payroll tax, and funds are allocated to states and local governments, who in turn hire providers (both private and public) through competitive bidding. States must present annual training plans to the PLANFOR administration, and funds are allocated in proportion to the state's share of the total workforce. This method of allocation is presently being changed to reflect the state's level of poverty and education and past experience with the execution of annual training programs. It is interesting to note that the national training institutions (in the case of Brazil, the SENAI-SENAC system) participate in the bidding process as another provider of training services, thus creating an interesting financial and institutional dynamic in the overall training system.

Costa Rica uses a national training institution as a channel for delivery of training services to semi-skilled and skilled unemployed workers. The national training institution uses its own facilities and instructors to schedule and deliver training programs for low-income workers in marginal urban areas, displaced public sector workers, and handicapped workers. A special line of action was established to enable the national training institution to contract out other training institutions, but no special targeting mechanism has been used.

Jamaica uses a number of programs to provide training for unskilled and young unemployed

workers, but the mechanism for income transfer is temporary jobs rather than scholarships during training.

Mexico has the largest training and income transfer program in the region, and effectively uses it as a protective device for unemployed and displaced workers. The PROBECAT program expands and contracts according to the economic cycle. It provides scholarships for the beneficiaries, and the state offices of the labor ministry organize a variety of training programs that are delivered locally. Program evaluations have found that the program has been somewhat successful as a training program, increasing income and likelihood of employment for beneficiaries, although positive effects tend to increase with higher levels of education of the beneficiary (STPS 1995). After 1999, the new Mexican administration engaged in a number of reforms of the PROBECAT program, with the basic aim of streamlining intermediation services for unemployed workers and, in some cases, reducing the training component. The available evaluations indicate that enhancing the link with intermediation services has produced positive results and reduced the costs of interventions (GEA and Associates 2003).

Short-term training programs work as an income support device through the provision of scholarships to trainees during the classroom training and apprenticeship periods, normally between four and six months. The scholarships are below the relevant market wage, and the apprenticeships take place in private firms with which the training providers sign an agreement. The short duration of the classroom training makes these programs more adequate for providing young new entrants to the labor market with job search skills than for meeting the needs of skill updating or upgrading of workers displaced from declining sectors.

³² The contracting mechanism of Chile Joven was in fact a way to create incentives for training providers to deliver good quality and labor market-relevant content in their courses. This created pressure for an institutional and content revamping of the training system, as firms accepting apprentices acted as controllers and gatekeepers of the relevance and adequacy of the training provided. The program was therefore rightly perceived as a tool to modernize and connect the training system with real productive activities.

The main challenge in the design of these training programs arises from the existence of a national training institution, normally a monopolistic public provider of training financed through a payroll tax with no incentive whatsoever to adapt the nature of its activities and clientele to the challenges of high unemployment. In order to circumvent this obstacle, a separate pool of resources managed by a specialized agent at the central government level organizes the programs. This agent in turn bids out resources to private providers that execute the training programs in a decentralized fashion. These decentralized providers must enter into agreements with private sector firms to ensure that trainees will have an apprenticeship stage, making private firms the effective gatekeepers of the quality and relevance of the training programs. Another interesting byproduct of this process is the development of stronger connections between firms and training providers, which make the latter effectively providers of job search assistance services.

Training programs tend to be more expensive on a per beneficiary basis compared with labor-intensive public works, given that a larger part of the resources goes to pay the training provider. However, calculations of benefits should include the long-term change in the structure of the training system and the development of job search assistance services, which are large positive externalities of these programs.³³

The organization of the programs makes it easy for the program organizer to administratively target groups of the population, and the programs have been quite successful in attracting unemployed youth. However, it should be noted that the programs could be too effective in attracting the target group. For example, in Mexico in 1996, youth participation rates increased so much that even if the employment rate of the group rose, so did its unemployment rate. Although there is no formal proof that this was the result of the expansion of training programs (particularly PROBECAT) that year, there is a suggestive association between expansion of the programs, decline in school enrollment rates, and increase in labor force participation and employment of the target groups.

Elías, Cossa, and Ruiz-Núñez (2001) analyze the impact of one of the rounds of the Joven program in Argentina on wages and likelihood of employment. The program offered a scholarship for participation in a training program (between six weeks and three months of classroom training and two months of practical training in a firm) to particularly disadvantaged segments of the labor force. The target population of the program was unemployed individuals between 16 and 30 years old, with less than complete secondary education and scarce labor market experience. One-third of the beneficiaries were female and two-thirds were younger than 24. Using a variety of matching estimators, the authors conclude that the main impact of the program was on wages, with only weak non-significant effects on the likelihood of finding a job. The wage effect is around a 10 percent increase over the previous wage, and the effect is stronger for females, implying that female trainees tend to benefit more from the training received through the program. In terms of cost-benefit analysis, the authors conclude that, depending on the assumptions about costs and assuming that the effects of the program last for five years, internal rates of return vary between 2.4 and 7 percent.

Aedo and Núñez (2000) use control groups and stringent estimation techniques to evaluate the same program's impact on wages and likelihood of employment. They report that females over age 25 are the only group that benefits in wage increases and likelihood of employment.

Bravo and Contreras (2000) use a change in the rules between two different waves of the Chilean Joven program to infer how changes in the incentive structure that training providers face can alter the placement of trainees. Until 1994, training providers received payment for delivering classroom training and placing the trainee in an internship in an enterprise, with no additional

³³ These emergency training programs have created the opportunity to introduce institutional innovation into a training system characterized by the monopolistic power of institutions financed by the payroll tax. Disseminating these innovations to the mainstream vocational training system will make it much more successful in addressing the needs of skill upgrading of workers caught in the normal process of job churning.

compensation if instead of an internship the trainee got a job contract. In 1995, a new rule was introduced in the program, by which the training provider would receive monetary compensation from the government if the trainee obtained a job contract instead of just an internship in a firm at the end of the training period. This change allowed the authors to compare placement rates before and after the change.

Bravo and Contreras conclude that changing the structure of financial incentives that training providers faced reduced the program's dropout rates and had a positive impact on placement rates. The authors calculate that placement rates increased by 13 percent after controlling for possible differences in the composition of the beneficiary group between the two waves using matching methodologies.

In summary, these programs tend to generate positive labor market externalities beyond the training process itself by easing the insertion of young workers and creating experience in the operation of labor market intermediation mechanisms (job search assistance). In terms of coverage, the nature of the training provided makes the programs suitable for unemployed youth. As is true for any training program, it should not be expected to create new jobs, but rather to provide new entrants with some labor market experience. Because youth unemployment is a permanent problem in the labor market, these programs should not be considered countercyclical devices, but rather a permanent feature of a well-functioning labor market intermediation system, which could be expanded and contracted following demand in a countercyclical way.

Cash Transfers

The most immediate and direct way to protect the income of unemployed workers is through cash transfers to families that fall below a predetermined income level. Although the criterion for receiving benefits from the program is formulated in terms of per capita family income, low family income levels are associated with unemployment or low wages (Hausmann and Székely 1999).

Cash transfer programs are usually targeted to the poorest segments of the population, which cannot obtain a minimum survival income level in the labor market. In many cases, a cash transfer is part of a more comprehensive program that aims to protect and further the ability of low-income families to maintain and accumulate human capital and, therefore, to graduate from the program.³⁴ Because these families are poor to begin with, economy-wide or even idiosyncratic shocks can put into question their ability to sustain minimum consumption levels. Therefore, a cash transfer could help them smooth their consumption levels.

The crisis in Argentina in 2001 was the scenario for a new type of cash transfer program, the *Jefes y Jefas de Hogar*, a basically universal program that targets unemployed household heads. The program provides a cash transfer to registered household heads and is not means tested. To be registered, the beneficiary needs to be unemployed and able to provide some hours of work, normally in a social service institution in the neighborhood. It is not clear whether this rule is well enforced, since control is in the hands of local government. Attempts to build social controls through the *Grupos Consultivos*, a consultation group formed by local authorities and civil society organizations, although not yet evaluated, seem to give mixed results. It is interesting that local authorities organize the works to be performed, but transfers are organized through the banking system. As access to the program is basically universal, benefits need to be rationed by queue, making the program's criteria for admission not quite transparent.

Cash transfers induce labor market distortions by increasing reservation wages and creating incentives against work. Because in most cases they do not require any counterpart work effort (making participation in the program effectively a free good), these programs also require a sophisti-

³⁴ The rationale for programs such as *Bolsa Escola* in Brazil, *Programa de Asignaciones Familiares (PRAF)* in Honduras, *Becas de Retención Escolar* in Argentina, and *Beca Alimentaria en Venezuela* is to avoid perpetuating a vicious circle of poverty. Thus, these programs require children to stay in school or women to attend primary health care facilities during pregnancy as mechanisms to prevent the transmission of poverty to the next generation.

cated targeting system and a complex system of verification and enforcement to avoid fraud by inclusion of families that are not needy and to avoid exclusion of needy ones. Cash transfers also tend to create strong entitlements among the beneficiaries, making it difficult to adjust either the number of beneficiaries or the amount of benefits in a countercyclical fashion.

Evaluations of conditional cash transfers show that the programs are effective in protecting the human capital of the poor. However, little is known from experience about the effects of unconditional transfers, such as the *Jefes de Hogar* program in Argentina. Recently, Argentina has released a new data set with information that would allow for an evaluation of this program.

Building Up a System

Skepticism about unemployment insurance in the region encompasses both the possibility of abuse and the negative effects on employment and output that would arise from reduced search effort by the insured unemployed. The concerns about abuse and corruption are quite understandable, particularly in countries where a large fraction of the workforce works in unregulated jobs or is self-employed. A poor record of enforcement of labor regulations does not help, as the absence of adequate registries of labor contracts with the labor authority make it difficult to imagine how eligibility for unemployment insurance would be assessed. Countries that do not have viable labor market enforcement and registration systems should privilege the creation of these capabilities over and above any discussion of unemployment insurance.

The possibility of establishing individual accounts increases social control over the insurance fund. This is an advantage for countries that have reformed the pension system to a system based on individual accounts (for example, as in Chile, Argentina, and Uruguay). Clear and well-enforced rules on contributions to the solidarity account from employers and the treasury should create enough formal controls for transparent and efficient operation of the system.

The creation of unemployment insurance raises concerns about the output and employment costs associated with reduced search efforts; these need to be weighed against the benefits that occur when longer searches by funded unemployed workers result in better matches and, therefore, a job mix that results in higher productivity and output. Acemoglu and Shimer (1999a) calibrate a model of the labor market for high school graduates in the United States; their results indicate that the benefits arising from better job matches of workers that searched longer outweigh the cost of foregone output and unemployment for moderate levels of unemployment insurance.

However, it should be stressed that unemployment insurance may increase labor costs and, therefore, have a negative effect on labor demand.³⁵ In order to minimize likely negative employment effects, unemployment insurance should be thought of as an offset for a reduction in legally established severance payments. In addition, unemployment insurance is sustainable only as a protective device and only for workers who have regulated and registered labor contracts. The temptation to temporarily extend benefits to noncontributors may arise for a government besieged by a macro crisis if eligibility conditions and benefits are not stable and well defined at the outset (even if they vary along the cycle). By contrast, well-defined eligibility conditions and reasonable costs may induce workers and employers to register labor contracts that otherwise would have gone unreported.³⁶

For workers who do not have access to unemployment insurance, a variety of mechanisms need to be put in place, depending on the reasons for their lack of access. These programs are a form of income insurance. An early example of this kind of program is the redeployment support programs that were used in the early 1990s to cater to the needs of workers affected by privatization of public

³⁵ For a discussion of the issue of labor taxes and their impact on labor demand, see chapter 7.

³⁶ This is one of the explanations that have been suggested to explain the surge in enrollment in the new Chilean system, which quadrupled the projections for affiliations after nine months in operation.

Box 8.2 Redeployment Support

Redeployment support aims to help displaced workers reenter the job market or become self-employed. Redeployment programs are politically and socially valuable, providing a tangible demonstration of government's commitment to help workers. Targeted programs can help assist workers in finding alternative employment.

There are limits to what can be achieved by redeployment alone. Economic policies that generate sustainable economic growth will offer the best prospects for displaced workers in the medium term. However, redeployment may provide important support for displaced workers. The main types of redeployment support are the following:

Counseling

In addition to advice on services on support open to the displaced worker, counseling might include elements of trauma, financial, and life counseling. Counseling is the first and minimum level of support that the implementing agency can put in place to help displaced workers. There are many types of counseling. Although it is cost-effective, counseling is often neglected, partly because of lack of clear guidance.

Job Search Assistance

Job search assistance can be valuable because it helps identify and match workers' skills to available job opportunities. Job search efforts show positive results and, when targeted, can be cost-effective. Job search assistance might include the following:

- Placement assistance (employment intermediation) to match workers with opportunities in the job market
- Time off for job search prior to termination of employment
- Assistance in building skills and confidence to find a new job (interview skills, personal skills assessment, writing job applications, and job clubs).

Training

Retraining is often the biggest element of a redeployment program, and often the most costly. Retraining can be pro-

vided for both formal employment and self-employment. The record such programs has been mixed. Retraining needs to be targeted and demand driven if it is to be cost-effective. Training might include the following:

- Retraining and development of new skills
- Training in small business, microenterprise, or other new areas.

Employee Enterprise

Facilities are provided by the government or privatized enterprises to enable employees to set up their own businesses. Some governments have helped employees set up their own enterprises to contract services that were previously provided by the state enterprise, or set up workspace and small business incubators. Employee enterprise may only help a small group of workers, but it offers the prospect of creating secondary employment. Employee enterprise might include the following:

- Contracting out services to newly separated workers
- Providing simple workspace facilities (sheds, garages, or small offices)
- Creating business incubators and supporting workspace facilities with business advice, shared facilities (fax and photocopier machines), and a degree of mentoring.

Community-based Approaches

Community-based approaches look to local government, NGOs, and community self-help groups, alone or in coalition, to develop employment opportunities at the local level. These can include public works programs that provide temporary employment opportunities through large-scale, labor-intensive projects. Involving the community in redeployment schemes is valuable in many redeployment circumstances, but particularly in regions or mono-industrial towns with large levels of local unemployment. Where there is chronic unemployment, both community approaches and public works can provide elements of active and passive labor market support.

enterprises (see Box 8.2). They use mechanisms of the training and intermediation system to deliver income support to workers excluded from the benefits of unemployment insurance. Financing constraints dictate that these programs be targeted.

In the first place, short-term training courses could provide low-skilled new entrants with the training, labor market experience, and job search assistance necessary to access a regular job. Scholarships should be set at a level low enough as to not

discourage search in the local labor market,³⁷ and targeting should concentrate resources on out-of-school unemployed youth. Careful attention should be given to attract exclusively individuals out of the school system, and therefore to deter school dropout caused by the program. Financing of this program should be obtained from the existing payroll tax earmarked for training, maintaining the system of decentralized provision with apprenticeships that has proved successful. Complementary funding (from either general fiscal resources or built-in reserves) should be provided in sync with demand for these services, and should be higher during economic downturns and lower during expansions.

This kind of program has numerous virtues, not the least important among them that it takes people out of the unemployment queue. However, there is an issue about the value of the training provided. In some cases, attending a training course should be an eligibility requirement; in others, the intermediation role of providing experience in the firm is more valuable. In any case, and given this design flexibility, programs of this nature should be subject to strict evaluation of their effects on wages and likelihood of employment (see Box 8.3).

For displaced low-skill workers, labor-intensive public works are the tool of choice in order to provide them with jobs at the local level. The innovation of these programs is that they do on a small scale what large public works did during the 1970s and part of the 1980s: stimulate labor demand through channeling public funds into construction works. The costs of providing complementary inputs are not trivial in a situation of fiscal contraction and, therefore, one of the temptations has been to reduce or simply eliminate the work effort requirement so as to reduce unit costs and expand the number of beneficiaries with the same resources. The paradox is, however, that these programs then become simple and unconditional cash transfers, losing a large part of the attraction of their original design.³⁸

The design of labor-intensive public works programs requires taking into account the level of development of local government and the nature of its financial and political relationship with the cen-

tral government. Many initiatives to set up employment generation programs have failed for not taking into account the organizational and political dimensions of the separation between financing and execution. Again, wage levels in the programs should be low enough so as not to crowd out alternative employment opportunities. Funding should be provided from general revenues and not, as is normally done, from payroll tax revenues.³⁹ Funding should be provided in sync with demand, with expenditure adjusting according to the evolution of the general or, if available, local unemployment rates.

Evaluations of the Trabajar program implemented in Argentina since 1997 present a number of important lessons about the design and impact of workfare programs. For example, the average gain for program participants in the late 1990s was about half the gross wage, and the distribution of gains was decidedly pro-poor (Ravallion 1999a, 1999b). The program's filtrations to the nonpoor are an essential element in maintaining the political support needed to implement the program. Not surprisingly, when it was cut in the midst of a deep fiscal adjustment, the program was cut in poorer areas and not in nonpoor ones (Ravallion 2000), thus increasing the anti-poor bias of fiscal adjustment.

The other member of the family of employment generation programs, wage subsidies, should be used sparingly, if at all, in spite of the conceptual attractiveness of the idea of generating real private sector jobs (as opposed to the make-work jobs of labor-intensive public works). The distortions caused by meddling with the relative wages of different types of workers are important enough as to counsel caution in this area. In any case, the sophisticated enforcement and supervision system

³⁷ The main criterion here is that the scholarship should be below the market wage that equivalent workers obtain in the labor market, and not a function of the overall average wage.

³⁸ It could be argued, for instance, that the Jefas y Jefes de Hogar program in Argentina is just a detargetting of the Trabajar program.

³⁹ The use of payroll tax resources (which increase the cost of labor and therefore reduce employment generation) to generate jobs is somewhat contradictory.

Box 8.3 Evaluation as a Tool

The rationale for program evaluation is straightforward. Without it, there is no reliable means for determining whether a program is achieving its objectives, whether the situation of the intended beneficiaries has changed, and what that situation might have been without the program. Anecdotal evidence and casual impressions alone are insufficient to manage programs that operate on a large scale and in some cases nationwide. Evaluations of programs and their impacts represent an important tool for testing the design and effectiveness of programs and determining whether time and money are well spent.

Moreover, evaluation at an early stage of a project can improve program design and targeting. Evaluation at an intermediate stage can further modify program design and increase the effectiveness of service delivery. In any event, the costs of evaluation represent only a small share of program costs, often less than 1 percent. The returns in terms of increased effectiveness of social spending and greater accountability are high.

Two main methods of evaluation are used. Both compare a treatment group of beneficiaries with a comparison group of nonbeneficiaries. When testing is conducted on a small scale, evaluators assume that the program has no impact on the economy as a whole. Evaluation of large-scale programs, however, should take macroeconomic effects into account.

The first method—the statistically ideal method—is experimental design. In this approach, members of the treatment and comparison (control) groups are randomly selected from a pool of eligible beneficiaries. Random selection serves both practical and ethical purposes. Many programs, particularly in their initial phases, simply do not have the resources to serve everyone who might benefit. Choosing members of the treatment group by what is in effect a lottery gives every member of the target population an equal chance of receiving benefits. The two groups can be compared for any indicator of interest, such as income,

consumption, school attendance, or labor force participation. Randomization can also serve as a model for program expansion and later phases of testing.

A second approach is quasi-experimental design. Using a variety of statistical and econometric methods, analysts take survey information that is already available to construct approximations of treatment and comparison groups. As with experimental design, the groups are then compared according to the indicators of interest. This approach has both drawbacks and advantages in relation to experimental design. The most notable disadvantage is that this method does not equalize the various sources of selection bias between the treatment and comparison groups in advance. Consequently, evaluations conducted through quasi-experimental design may yield less reliable results.

The quasi-experimental approach nonetheless enjoys several practical advantages. First, this approach is generally less costly to implement, as it typically involves pre-existing surveys and no baseline (or pre-program) surveys. Second, quasi-experimental design can prevent delays in service delivery that would result from planning, carrying out, and analyzing an experimental design. Finally, a quasi-experimental approach may be better suited to accommodate political constraints: politicians are often (understandably) more interested in distributing benefits than waiting for the most accurate findings. Along similar lines, members of the public are more interested in receiving benefits than not.

Whatever method is used, some kind of evaluation is far better than none at all. Planning, managing, and expanding social programs without the tools of evaluation is inconceivable. When rigorous and thorough evaluations take place, policymakers and administrators can make better use of limited government funds and personnel and are thus able to direct resources to programs that have the greatest positive impact on social welfare.

needed to mitigate the deadweight and substitution effects of these subsidies is not present in most countries.

Finally, cash transfers to poor families are the last resort mechanism to support those families that fall through the other support mechanisms. This is the point where labor and poverty policies intersect in a strong way. The complications of their design and implementation are well known, and extreme caution is recommended, given that

the program can create dependency traps for beneficiaries. Although it is too soon for a thorough evaluation of a program like *Jefes y Jefas de Hogar* in Argentina, it has undoubtedly fulfilled a positive role in at least temporarily containing the social consequences of the increase in unemployment at the end of 2001. The fact that in practical terms the program is not targeted to poverty, just to unemployment, makes it even more important to carefully evaluate the program's impact.

UPDATING AND IMPROVING THE WORKERS' SKILL BASE

The fact that skill-related wage differentials are increasing in the region, unwelcome as it may be from the distributive point of view, creates an opportunity to increase the skill level of the workforce. The wage incentives are set as a clear signal of increased earning opportunities arising from higher skill levels. For this to happen, the education and training systems need to improve their operations.

The principles of training policies are well understood and essentially refer to the question of how to link effectively the demand and supply of skills. There is a widespread perception in the region that globalization and economic integration are making training policies more important. A well-trained workforce is key for providing domestic firms with a competitive edge, and workers require a higher level of skills to adapt to accelerating technical and market changes. At the same time, however, the increase in precarious and casual forms of labor contracts reduces the incentives that both firms and workers face to invest in developing and acquiring new skills.

Much of the policy debate focuses on the reform of public training institutions, rather than on the wider set of private and public institutions and practices that determine how workers acquire and apply new skills. Training is a public policy problem, but it affects both public and private actors. Interaction between the government and social partners (the private sector and unions) is key to any feasible solution. Improving the performance of the training system requires more than reforming public training institutions; changes in tax, education, and labor market policies are crucial in this task.

Private firms do train their workers, and the shape and intensity of this training effort are similar to what is done by comparable private firms in the United States and Canada (IDB 2001). Training policies have to operate in an institutional structure that involves the actions of workers and unions, firms and business organizations, and government. The institutional and organizational

capabilities of each of these actors contribute to give the training system a particular shape in each country.

Training systems in the region have evolved differently from a common original model, mostly as a consequence of the different sets of circumstances and institutional capabilities that governments, the private sector, and unions have had in each country. Training systems are in a fluid organizational and institutional state. In most countries, the training system performs poorly and shows little or no ability to innovate. In some countries, however, the training system that has evolved allows for experimentation and innovation in training provision.

In spite of the variety of organizational contexts, there is a general perception that the performance of training systems is poor, and that its products are not relevant or even opportune in terms of the needed skills. Recent evaluation efforts suggest that this pessimistic assessment is not off the mark. For example, Medina, Meléndez, and Seim (2003) study the impact of the training system in Colombia. It encompasses a number of public and private institutions that offer training programs and the Servicio Nacional de Aprendizaje (SENA), an important public institution that regulates the system and owns and operates training facilities. The study finds that youth training has no statistically significant impact on income, except for a long-term impact on the future wages of young females who train in private institutions. For adults who train at SENA or other public institutions, training has no short or long-term impact on income. Adult males who train at SENA show a negative impact in the short term, but no impact in the long run. For adult females who train at SENA, the impact is positive in both the short and long term. Adults who train at private institutions enjoy a significant long-term increase in income, although there is no impact in the short run.

Tinkering with the institutional structure of a country's national training institute cannot solve this poor performance, although much needs to be done there. It is clear that neither provision nor regulation of training needs to be public, or even that being public would make the system work bet-

ter. However, strong regulation and effective enforcement of quality and relevance standards for training programs are needed for any policy to work. The regulator should be separate and independent of any other entity that operates training programs to avoid conflicts of interest that could arise from bureaucratic encroachment. As in any market, regulation operates best when it is separate from provision.

Universalizing basic education and easing the transition between school and the labor market are crucial to give workers the opportunity to acquire the basic skills that are a prerequisite of the more specialized skills that firms may want to offer. Tax policies could also fulfill an important role, both to subsidize the cost of training for individuals that choose to invest in learning new skills, and to subsidize the investment that firms make in training their workers. At the least, investment in human capital should receive the same tax treatment as capital investment. Labor market regulations also need to be attuned to this process because productivity is a function of contractual relations and working conditions within the firm. Contractual innovations (including apprenticeship contracts) would allow workers and firms to share in the cost of training.

Achieving sustainable growth requires, among other things, a sustained rhythm of increase in labor productivity, which can only be the result of improved educational attainment for the population at large and a higher level of skill supply and demand. Training policies should not be seen in isolation: their effectiveness and success depend on a number of policies that structure the incentives for firms and workers to demand and supply skills.

First and foremost is the education policy. Universalizing basic education up to ninth grade is a necessary condition, but far from sufficient to support a process of skill development. The school system needs to show flexibility and attractiveness to give students the incentive to stay in the school system beyond basic education. This is not necessarily an argument in favor of vocational education as a specialized, closed-end feature of the education system. Rather, easing the transition between

school and the labor market and vice versa is crucial for giving undereducated workers the opportunity to acquire the basic skills that are a prerequisite of the more specialized skills that firms may need. In this sense, the Mexican initiative *Educación para la vida y el trabajo* shows conceptual promise because it opens new channels of communication between school, training, and the labor market.

Adult education needs to be expanded, given the low educational attainment of the population at large and active workers in particular. Alternative models of delivery that are suitable for adults who are either working or looking for a job will be a necessity, probably implying a more intensive use of existing educational facilities and the design of accelerated, examination-based accreditation programs. Subsidizing the financial and foregone earnings costs of acquiring more education is a legitimate means for increasing the demand for adult education. In particular, these efforts should be expanded in periods of high unemployment, when the cost of foregone earnings falls substantially. If subsidization included the provision of income support contingent on results to adults re-entering the education system, these programs would also have the nontrivial benefit of keeping workers out of the unemployment lines. However, policymakers should resist the temptation to use adult education as an income support program. If the quality of the education delivered is deficient, program participants will be stigmatized and the program will lose its effect on the future earnings of trainees.

In Chile, a tax rebate (the *franquicia tributaria*) subsidizes a wide variety of training programs, including programs for disadvantaged groups. This kind of intervention produces little or no interference in the training decisions of firms and workers. However, in the absence of strong regulations based on objective criteria about the quality and relevance of the training programs, this policy might be a waste of resources if firms and workers acted opportunistically.

Labor market regulations also need to be attuned to this process because productivity is a function of contractual relations and working conditions within the firm. Contractual innovations

(including apprenticeship contracts) that allow workers and firms to share in the cost of training through a reduction in wages, and that eliminate the legal presumption of existence of an indefinite labor contract for trainees, serve to increase the supply and demand for skills. However, it should be kept in mind that opportunistic behavior could result in the use of trainees as a cheap labor force in the absence of strong and effective enforcement of quality and relevance standards for the training programs. If these innovations reduced separation costs below normal levels, firms and workers would have fewer incentives to acquire skills, given the increase in the likelihood of termination.

Workers and firms would benefit from wider availability of information about jobs and educational opportunities. Labor market intermediation services, which support unemployed workers' search efforts, could help to ease the flow of information and help workers find training opportunities while searching for a job. The post-1995 experience of operation of income-support programs shows that their effectiveness could be enhanced immensely by offering a menu of options (including training and educational opportunities), as opposed to just cash transfers (Márquez 2000).

Training programs should also be included in collective bargaining, thus giving firms and unions the opportunity and the mechanisms to bargain on the level of investment aimed at skill development. Unions and employers operate training facilities in a number of countries in the region, some of them of quite high quality. Regulation and direct government intervention to foster the creation and orderly use of local or regional councils of workers and firms aimed at development and operation of training programs would ease the coordination problem and probably increase the quality and relevance of the training offered. These programs operate at the local or regional level, where unions and employer organizations have more control over their performance.

Mechanisms to protect the income of unemployed workers (including severance pay and unemployment insurance) should include subsidies for training, preferably in the form of voucher-

like instruments that workers could negotiate as part of their job search strategy. The post-1995 experience in the region shows that short-term training programs for unemployed workers are not star performers in increasing the future earnings of beneficiaries, although they seem to enhance employability at least for adult women. No experimental evidence is available on the impact of programs that send the unemployed back to school to acquire basic skills, but experimentation in this area should be encouraged and could be used to support the expansion of adult education.

There is no clear "best" model for the institutional layout of training systems, but there are a numbers of do's and don'ts that should orient policies in this area. The poor record of the traditional national training institutions in most countries in the region shows that the corporatist model of organization isolated the system from workers and firms, and that these institutes need to be redesigned. A strong public regulator of the training system needs to be in place in order to set and enforce quality and relevance standards for training programs. Because of the central nature of this institution in labor market policies, it is natural to think that it should depend on the labor ministry, rather than the education authority. The regulator should be separate and independent of any other public entity that operates training programs to avoid conflicts of interest that could arise from bureaucratic encroachment.

As in any market, regulation operates best when it is separate from provision. This does not imply the endorsement of an enlightened but isolated public bureaucracy: the regulator needs to earn the trust of the private sector and, for that, needs to interact with the institutional representations of workers and firms (and not just with training providers) and be governed by their demands. The corporatist model works only if the institutional representations are strong and focused on competitiveness (as seems to be the case in Brazil), rather than on the defense of the status quo. When unions and chambers of industry and commerce are weak, the corporatist solution degenerates into a bureaucratic quagmire that consumes inordinate resources with little or no social return.

More flexible forms of coordination with the private sector and unions should be stimulated, including the creation of local/regional and sector-specialized councils that can inform and direct public training policies in a setting and scale that are more agreeable with the institutional capabilities of unions and the private sector. Skill certification is an important tool in this process, in the sense that it solves an information problem by making the quality and quantity of workers' skills observable by potential employers. However, certification requires the strong institutional participation of firms, workers, and unions in the design of content standards and the mechanisms for accreditation.

The existing training systems have been charged with remedial training and education, and it is likely that they will continue to be involved in this area, given the deficits in basic skills of the labor force. The problem is that these programs tend to have little impact on beneficiaries and therefore low social returns. These programs should not be financed without stringent and continuous evaluation that allows for flexible redesign of program content, method of delivery, and clientele. On the positive side, these programs have served to open up the spectrum of training providers and have been strong forces for change in the training system. In particular, the programs need to be integrated with placement and intermediation mechanisms, keeping in mind that the ultimate objective of remedial training is to place trainees in productive jobs where they can continue to develop their skills. This implies that actions to facilitate job search, including subsidies and counseling, should be an integral part of remedial training programs. The labor ministry should profit from this opportunity to enhance the structure and performance of the placement and labor market intermediation services it provides.

In the past decade, governments in the region have implemented new programs and set up new institutional structures in the training system. This is a welcome process whose momentum should be kept up. However, most of these new programs have been set up as transitional devices to counteract the adverse consequences of unemployment and low incomes. Authorities should not forget that

the ultimate mission of the training system is to provide the population at large with the level and mix of skills needed for workers and firms to create the more productive jobs associated with a more competitive economy. This implies that every action in the training system, from basic remedial training to the more sophisticated skill certification process, should be evaluated in terms of its effectiveness and cost efficiency in the attainment of that objective, rather than on its effectiveness in containing the adverse social consequences of unemployment.

ENFORCING THE SOCIAL CONTRACT

Labor policies and regulations need to be enforced. In order to effectively enforce the social contract, countries will need to invest in the development of the institutions of labor policies, both those that collect, analyze, and process information, and those that implement policies and enforce regulations. Scarcity of resources and institutional deterioration are two traits that characterize the institutions in charge of labor policies (mostly ministries of labor). The low level of enforcement of labor regulations that results is not beneficial to the effectiveness of labor policies; important investments are needed in just setting up the institutional abilities and capabilities to implement labor policies. On the one hand, significant investments need to be made in labor market data collection and analysis. On the other hand, and more importantly, significant investments are needed to rebuild the capacity of the labor administration authority (normally the ministry of labor) to enforce regulations and analyze and design labor policies and instruments.

Hard data on enforcement resources are difficult to obtain. The data in Table 8.6 present the limited information that the labor ministries could provide regarding both a measure of human resources (number of inspectors per 100,000 workers) and an imperfect indicator of enforcement results (number of fines imposed in connection with noncompliance with some aspect of labor regulations per 100,000 workers).

Table 8.6 Enforcement Capacities of Labor Ministries in the Region

Year	Inspectors per 100,000 workers			Number of fines per 100,000 workers			
	Argentina	Brazil	Peru	Argentina	Brazil	Mexico	Peru
1990		5.61			1.41	0.26	
1991		4.99			1.46	0.24	
1992		4.27			1.44	0.22	
1993		3.95			1.89	0.21	
1994		3.54	0.24		1.67	0.21	
1995		3.20	0.55		1.54	0.44	
1996	4.40	4.64	1.13	7.95	1.54	0.51	
1997	4.10	4.37	1.12	7.30	1.82	0.50	
1998	4.03	4.00	1.11	6.24	1.58	0.45	0.62
1999		4.07	1.11		1.46	0.33	1.81
2000		3.82	1.09		1.31	0.29	2.88
2001		3.70	2.23		1.25		0.75
2002		3.63	2.21		1.17		1.76
2003			2.19				

Source: Data on the number of inspections and fines are from the ministries of labor; data on the number of employees are from ILMF (various years).

It is worth noting that many workers do not have employment contracts with full benefits; they are self-employed or work in casual, unregulated jobs. Massive noncompliance with benefit and working conditions regulations adds complexity to the enforcement task and new approaches need to be sought to expand the coverage of inspections and other mechanisms to increase compliance.

Labor ministries have an enormous regulatory task, encompassing occupational safety and health regulations and issues of basic labor rights, such as freedom of association and bargaining. The ministries are expected to organize a wide range of services, from intermediation to training. Based on their wide charter of action and shallow pool of resources, it is not surprising that the ministries have often failed in fulfilling their mission. Labor ministries need support in the areas of inspection services, labor administration, and registry.

Renewed efforts need to be directed toward enhancing the regulatory and enforcement capabilities of the labor authority, and new forms of fulfilling old (and new) functions need to be created. The evolution of training systems is an interesting example of how the new institutions of labor policy are being created. Of the numerous developments in this area, two areas deserve special considera-

tion. One is the work on competency certification programs, in which the government and the private sector are working together to create a self-sustained system of standard setting and certification to enhance the mobility of workers across jobs (see Box 8.4). Another area where innovative efforts are being made relates to occupational safety and health (see Box 8.5). A common trait of these efforts is that they involve private (often for-profit) providers of intermediation, placement, and training services. These innovative new models of collaboration between the public and private sectors should be expanded.

FINANCING LABOR POLICIES

Countries in the region invest a smaller fraction of GDP in unemployment insurance, employment generation, and training-cum-income transfer programs than a wide sample of more developed OECD countries invest.⁴⁰ Table 8.7 presents evidence for the seven countries in the region for which comparable data are available. On average,

⁴⁰ This section is based on Braun and di Gresia (2003).

Box 8.4 Skills Standards and Certification Systems¹

Better information about workers' abilities and capabilities should increase both the productivity of search and the productivity of job-worker matches. This is the basic premise behind the new wave of skills standards and certification systems that a number of countries in the region are developing with (and some without) financing and technical assistance from the Inter-American Development Bank.

Skills standards are the abilities, skills, knowledge, and operations that an individual should possess for a specific occupation. Certification systems are institutional mechanisms that provide testable evidence of a worker's competency to perform the specific functions described by the applicable skills standard. Accreditation systems are necessary complements to ensure the quality of training delivered by a multiplicity of public and private providers. Once operational, the skills standards and certification system makes more information available on the skills and qualifications of workers, which benefits companies, workers, and society as a whole. For companies, the system provides objective information on workers' skills, thus reducing hiring costs and enhancing the ability to manage human resource development internally. For workers, the system provides a validated means of proving their skills and abilities, thus increasing their marketability and job mobility. For society as a whole, the skills system makes for more fluid and effective linkages between employment and skills, and provides an objective measure to assess the impact of training.

Developing comprehensive skills standards is a complex process. Experience shows that projects must be demand-driven so as to engage the productive sector in the design and utilization of the standards in everyday practice. Financing for the standards certification system should be provided by the private sector, although some initial government support may be needed. The system itself should be led by the private sector and managed by a body with a broad representation of labor and the public sector. Although standards will most likely be simple at the beginning, their quality and level of detail will need to evolve substantially with broader use. However, the crucial test of a skills standards system is whether it is used by the private sector as a tool in human resource management functions.

In Mexico, the development of skills standards was part of a public sector led initiative that is notable for its sheer scale. Between 1996 and 2000, more than 530 standards were developed and more than 42,000 workers

were certified through the actions of the Consejo de Normalización y Certificación de Competencias Laborales (CONOCER). The hotel chain Grupo Posadas and the food retailer Bimbo, both major private sector companies, are adapting those standards for their own use. The Comisión Federal de Electricidad, a public electricity distributor, is planning to certify its 80,000 workers. Efforts are presently underway to strengthen the link with the training system through the adoption of competency-based training.

In Brazil, the Instituto de Hospitalidade was the hub of a national certification council that included representatives of business, labor unions, and government and educational institutions. Fifty-two standards were developed and validated in consultation with employers, workers, and trainers. As a result, nearly 12,500 workers were certified and more than 400 trainers were trained. Super Club, an international hotel chain operating in Brazil, is using the standards to train its entire workforce at its resort near Salvador.

In Chile, the Fundación Chile, an independent, non-profit organization, worked closely with the National Training and Employment Service (SENCE) to produce 271 standards and train more than 4,000 workers over a three-year period.

The experimentation with skills standards and certification systems is a long-term process that has just recently begun in the region. There is a growing network of institutions through the region and much is being learned. There is an understandable enthusiasm among practitioners because of the increased private sector involvement that the skills system implies. However, this enthusiasm needs to be tempered by hard data on the impact of the skills system in increasing productivity in the firms and sectors involved.

Work needs to be developed in assessing the market penetration of the certification system. Evaluation of the impact of the skills system requires answers to the questions of who gets certified, which companies are purchasing certifications, and what competencies are being tested. Evaluations should be based on the market adoption of standards and use of certification, rather than on outputs (such as the number of standards and the number of certified workers).

¹ Based on Kappaz and Siegel (2002).

Box 8.5. Occupational Safety and Health Policies in the Region

Concerns about occupational safety and health extend well beyond the obvious health consequences of work-related illnesses, accidents, and deaths.¹ Occupational safety and health issues are directly linked to labor productivity, household income and poverty, the social security system, international trade, and even the environment. However, occupational safety and health issues have received little attention in Latin America and the Caribbean due to the lack of awareness regarding the importance of a safe and healthy work environment, and to the weakness of the institutions responsible for the promotion and enforcement of better working conditions.

Analysis of the incidence and impact of workplace diseases and accidents in Latin America and the Caribbean must take into consideration the limits imposed by widespread underreporting of accidents and illnesses and the frequent exclusion of entire sectors from information systems. Although reliable and comparable data on occupational accidents, injuries, and deaths are difficult to obtain, estimates for the region indicate that the social and economic impact of the unsafe work environment is significant: conservative figures show that it costs the region at least 27,000 deaths, 20 million injuries, and 4 percent of GDP. Furthermore, conditions observed in the region are more dangerous than those found in developed economies and even other developing regions. As a consequence, a substantial proportion of the regional effort to promote and develop its human resources is unnecessarily being lost in a workplace that is generally unsafe and unhealthy.

Addressing occupational safety and health problems requires dealing with overlapping responsibilities between ministries of labor and health, and between private insur-

ers and social security institutes. It requires the cooperation of business associations and worker unions, international trade negotiators, and environmentalists. And it entails making decisions with significant distributional and health consequences. The key determinants of workplace health and safety conditions in the region require policy interventions that go well beyond the boundaries of occupational safety and health and into the realm of labor sector reform and social and macroeconomic progress.

The most obvious of the economic policies are those related to the labor market itself. Fiscal policies can also be used to promote low-risk activities and safe work environments through the use of fiscal incentives to encourage the use of safety equipment and/or to stimulate the development of low-risk industries. Furthermore, preferential interest rates and financing mechanisms can be used to support firms, particularly small and medium enterprises, in acquiring safer equipment and tools.

Health and safety conditions at work will not improve in the region without better standards and improved regulatory and incentive structures. Occupational safety and health standards need to be mandatory, universal, and enforceable. However, regulatory systems should not be limited to the traditional enforcement approach: the regulatory and incentive-based approaches are not mutually exclusive alternatives, but rather form a continuum that reflects the emphasis placed on one scheme or another. In fact, the two approaches tend to reinforce each other.

Efforts to improve regulations and incentives depend on each country's institutional capacity. Systems that emphasize regulations require a well-organized and

the countries in the sample spend less than 0.5 percent of GDP on these programs, while the average for the OECD countries is 2.4 percent of GDP. Only the United States and Japan, both countries with particular labor market structures, spend a smaller fraction of GDP on these types of programs.

Within the region, Mexico spends the most resources on employment generation (0.5 percent of GDP) to benefit around 4 percent of the total workforce. Argentina reports expenditure below 0.1 percent of GDP to benefit around 9 percent of the total workforce. Resources invested in training programs are of the same order of magnitude as those dedicated to employment generation pro-

grams, although the number of beneficiaries seems to be somewhat greater.⁴¹ Furthermore, the countries in the region that have unemployment insurance systems (Brazil and Argentina) spend less on unemployment compensation than the OECD countries that spend the least on unemployment.

These figures suggest that there is room for expansion of expenditure on income support programs. Even doubling the expenditure on these programs (an increase well beyond any reasonable short-term expectation) would not make countries

⁴¹ These figures exclude the expenditure of the traditional national training institutions.

financed government structure capable of defining, implementing, and enforcing appropriate principles, rules, and standards. An emphasis on incentives, by contrast, requires an insurance industry that is large enough to allow competition and sophisticated enough to be able to address the specificities of the different markets and individual firms, and a public sector with adequate institutional and regulatory capacity.

It must be noted, however, that the implementation of a structure of incentives is a complex proposition that imposes an important set of demands on the overall occupational safety and health system. First, the risk assessment and insurance functions need to be separated in order to avoid conflicts of interest. Second, the number of insurers and risk assessment firms must be large enough to ensure that neither market is an oligopoly or an oligopsony. Third, the definition of whether the firm or the insurer contracts the risk appraiser is critical: in the first case, the appraiser may have an incentive to underestimate the risk level of the firm in order to obtain a lower premium for its client; the opposite incentive would apply if the insurer were the client of the risk assessment company.

Smaller countries and/or those with weaker institutional capacity should maximize the capacity of the system to induce changes in the behavior of economic agents through a system that places relatively more emphasis on a regulatory structure based on clear and well-defined standards on which a good enforcement strategy can be executed.

Workers need to be better informed and educated in the use of occupational safety procedures and equipment, particularly in those industries that present relatively high

risks, since the positive impact of these measures in such industries can be significant. Simple measures, such as adequate ventilation, proper use of safety equipment, and unobstructed work areas, could go a long way toward reducing occupational risks in the region. Health professionals need to be trained to recognize occupational injuries and particularly occupational diseases. Occupational safety and health inspectors also need to be trained. Better-trained workers, managers, health professionals, and regulators tend to generate better reporting and information systems, which, in turn, would provide the inputs to further improve the quality of training and education.

A strategy that coordinates the efforts and actions of the technical and financial multilateral agencies that are working with occupational safety and health issues in the region is particularly desirable. The relative strengths of each institution could be used to tackle the complexity of issues that determine the occupational safety and health conditions in the region.

Countries in Latin America and the Caribbean have many opportunities to improve occupational health and safety in ways that are cost-effective. Simple measures can go a long way toward reducing occupational risk in the region. In fact, there might not be a trade-off between improved safety and health conditions and costs because reducing occupational hazards may indeed improve labor productivity.

¹ Much of the information presented here is based on Giuffrida, Lunes, and Savedoff (2003).

in the region big spenders in international terms. However, size is not the only problem that affects expenditure on income support programs; lack of opportunity also hinders effectiveness. Because labor market programs are procyclical, as is overall fiscal expenditure, these programs tend to expand in good times and contract in bad times. Income support programs and social policy as a whole tend to follow this pattern.

Countercyclical fiscal policy is a key element for dealing with crises. Many of the recent proposals for reducing aggregate macro volatility in Latin America mention the importance of the potentially stabilizing role of fiscal policy (de Ferranti and oth-

ers 2000). Most importantly, social insurance requires countercyclical fiscal policy by construction because it requires transferring income from booms to recessions. An adequate unemployment insurance scheme would automatically increase government expenditure as unemployment increases during a recession, and automatically reduce expenditure when employment recovers.

Countercyclical fiscal policy is also a key element for integrating social insurance with a well-funded safety net.⁴² Unfortunately, the evidence

⁴² That is, the elasticity of total spending to GDP per capita should be negative (and as large as possible).

Table 8.7 Expenditure on Labor Market Programs in OECD and Latin American Countries*(Percentage of GDP)*

Country (year)	Training for unemployed	Employment generation	Unemployment compensation	Total
<i>OECD countries</i>				
Australia (1994–95)	0.23	0.21	1.62	2.06
Austria (1995)	0.13	0.05	1.30	1.48
Belgium (1995)	0.24	0.68	2.11	3.03
Canada (1994–95)	0.29	0.07	1.50	1.86
Denmark (1995)	0.86	0.36	3.06	4.28
Finland (1995)	0.60	0.68	3.57	4.85
France (1995)	0.67	0.40	1.43	2.50
Germany (1995)	0.44	0.44	2.08	2.96
Greece (1995)	0.04	0.09	0.44	0.57
Italy (1995)	0.39	0.69	0.68	1.76
Japan (1994–95)	0.03	0.06	0.39	0.48
New Zealand (1994–95)	0.44	0.15	1.26	1.85
Spain (1995)	0.33	0.31	2.46	3.10
Sweden (1994–95)	0.98	0.90	2.51	4.39
United States (1994–95)	0.07	0.01	0.35	0.43
<i>Latin American and Caribbean countries</i>				
Argentina (1995)	0.04	0.09	0.14	0.27
Brazil (1995)	0.06	0.21	0.19	0.46
Chile (1995)	0.03	0.00	0.00	0.03
Costa Rica (1995)	0.73	0.04	0.00	0.77
Jamaica (1995)	0.44	0.50	0.00	0.94
Mexico (1995)	0.04	0.51		0.55
Peru (1995)	0.01	0.19	0.00	0.20

Note: Training for unemployed includes training for unemployed adults and those at risk, plus measures for unemployed and disadvantaged youth and support of apprenticeship programs. Employment generation includes all forms of subsidized employment, plus direct job creation by the public and nonprofit sectors. Unemployment compensation includes all expenditure on benefits, independent of source of financing.

Source: For OECD countries, OECD (1998); for Latin American and Caribbean countries, Verdera (1998).

shows that fiscal policy tends to be procyclical in Latin America, thus leading to higher economic volatility and acting as a constraint on the possibility of establishing an adequate safety net. The recent literature on crises and poverty discusses options for reducing the volatility of Latin American economies and the design of adequate safety nets.⁴³ However, not much emphasis has been placed on studying specific ways of reducing the procyclical behavior of fiscal policy.

Social spending is strongly procyclical in Latin America: governments tend to increase pro-poor spending during expansions and reduce it during recessions.⁴⁴ Volatility is a key determinant of procyclical fiscal policy: the more volatile is growth, the more volatile is fiscal policy.⁴⁵ Braun and di Gre-

sia (2003) analyze the correlation between procyclical fiscal policy and GDP volatility for a sample of 88 countries including OECD and Latin American countries. Their results confirm that blessings come in pairs: OECD countries tend to have both low volatility and low procyclical fiscal policy, whereas Latin American countries have both high volatility and high procyclical fiscal policy. Latin American

⁴³ Ferreira, Prennushi, and Ravallion (1999); Lustig (1999); Lustig and Walton (1999); de Ferranti and others (2000).

⁴⁴ Wodon and others (2002) find that social spending per poor person falls by 2 percent for each 1 percent reduction in GDP per capita.

⁴⁵ Gavin and others (1996); Talvi and Végh (2000); Gavin and Perotti (1997).

governments are as pro-poor as OECD governments, but the adjustments in fiscal policy are relatively too large for the smaller Latin American governments to absorb. The differences between Latin American and OECD countries in procyclical social spending can be explained by the differences in the behavior of overall fiscal policy.

Countries in Latin America have been somewhat able to protect social expenditure, but are limited in their efforts by the depth of the fiscal adjustment needed. In more practical terms, protecting specific items of social spending during crises is often the only feasible policy and it may be an important second-best policy. However, the impact of such a policy is limited in scope given the size of the fiscal adjustment that is being undertaken at the same time.

Fiscal policy is particularly procyclical in Latin America because both the automatic and discretionary responses of the budget to the cycle are more procyclical than in developed countries (IDB 1997). It is difficult to disentangle the causality and relative importance of the competing explanatory factors of procyclical fiscal policies. However, there are several differences between Latin American and OECD governments. Fiscal policy is probably more procyclical in Latin America because the automatic response of fiscal policy is less countercyclical than in the OECD⁴⁶ because Latin America has smaller governments and a smaller proportion of automatic stabilizers in public spending (for instance, limited unemployment insurance). The discretionary response of fiscal policy (especially spending) is more pro-cyclical than in the OECD because Latin America is characterized by volatility, discretionary policies, political constraints, weak fiscal institutions that make saving in good times difficult, and limited credit-worthiness.

What can governments do to limit this problem? Country experience suggests a menu of policy choices for reducing the procyclical effects of fiscal policy. The menu includes the following:

- Fiscal stabilization funds that would collect surpluses during good times and that could be spent during recessions

- Numerical fiscal rules to limit the growth of spending and debt during expansions
- Reform of the structure of federal fiscal transfers to reduce the procyclical effects of subnational spending⁴⁷
- Increases in the proportion of automatic stabilizers in total spending
- GDP-indexed bonds, which would limit the need for fiscal adjustment during recessions by automatically reducing interest payments.

Unfortunately, the evidence shows that, in many cases, isolated measures do not work. For instance, fiscal rules and stabilization funds in many countries have failed due to unexpected shocks and politically motivated noncompliance.⁴⁸ Given that many of the above proposals do not alter underlying political incentives to increase spending during good times, the mixed results are not surprising. However, new developments in some countries, such as Brazil's Fiscal Responsibility Law and the Chilean structural surplus rule, and recent research allow for some optimism.⁴⁹ An integrated country-specific approach (as opposed to a one-size-fits-all approach) that takes political constraints seriously seems to be key for success.

Recent experience suggests working in at least three directions, as summarized in Table 8.8. In the first, policies should be adopted to increase the role of automatic stabilizers in the budget, as long as this can be done along a sustainable fiscal path. This is not easy; Bourguignon (2000) shows that Latin America's "welfare state" is similar in size and scope to that of Europe in the 1920s/1930s.

⁴⁶ Martner (1999) estimates that the average elasticity of the cyclical surplus to growth is 0.2 percent of GDP in Latin America, compared with estimates closer to 0.5 percent of GDP in the European Union.

⁴⁷ For example, making transfers constant, as opposed to linking them to procyclical tax revenues.

⁴⁸ See Braun and Tommasi (2002) for a discussion of some failures of fiscal rules in Latin America.

⁴⁹ Spiller and Tommasi (2000), for instance, develop an in-depth analysis of the Argentine political system, and use the framework to propose incentive-compatible policy proposals. Von Hagen, Perotti, and Strauch (1997) propose a multi-step process to achieve fiscal sustainability in the European Union.

Table 8.8 Summary of Policy Options for Reducing Procyclical Effects of Fiscal Policy

Objective	Domestic policy	International financial institutions
Increase automatic stabilizers	Unemployment insurance and other policies; increased size of government	Insist on transparency and accountability
Improve savings during good times	Fiscal rules to reduce discretion and limit spending and debt during good times; fiscal stabilization funds; reform of fiscal institutions	Countercyclical lending
Improve creditworthiness during bad times	GDP-indexed bonds	Countercyclical lending and contingent credit lines

Excluding spending on education, Latin American countries spend on average 10 percent of GDP on social protection, compared with 15 to 33 percent in developed countries.⁵⁰ It took Europe several decades of post-war economic growth to develop its current welfare state institutions. Recent literature suggests that efforts to improve the efficiency of the public sector, improve transparency in the budget, and fight tax evasion should be promoted (Alesina 1999). The objective should be to help Latin American countries “switch” toward a better equilibrium with improved social protection and lower tax evasion. However, results will probably not be forthcoming immediately.

The second prong should aim at implementing fiscal institutions that limit discretionary spending and pressures to increase spending during good times. A combination of macroeconomic volatility and political-institutional constraints explains to a large extent the lack of fiscal savings during economic expansions. Powerful groups struggle for parts of the common pool of fiscal resources. This struggle generates pressure for increased spending during good times, and the pressure is greater the larger the fiscal surpluses. Therefore, volatility—which generates large surpluses in booms and large deficits in recessions—makes savings during good times even harder. Approaches proposed in this direction include fiscal rules (Kopits and Symansky 1998), stabilization funds

(Braun and Tommasi 2002), and revamping fiscal and political institutions (Hausmann and Stein 1996; Perry 2002; Stein, Talvi, and Grisanti 1998).

The third approach involves the development of financial instruments to improve access to credit during recessions or, in other words, to provide better insurance against shocks. A specific proposal by Borensztein and Mauro (2002) is to convert a significant proportion of debt issued by Latin American countries to GDP-indexed bonds. The idea is that bonds would pay higher interest when GDP growth is high, and less during recessions. This would reduce the need for rolling over debt or adjusting spending during recessions. Furthermore, increases in (inflexible) primary spending would be limited during expansions, because part of the extra surplus would automatically be used to pay debt service. Therefore, it would limit the problem of lack of creditworthiness and reduce procyclicality of spending. The role of international financial institutions is key in this kind of proposal because the markets for this type of security are still underdeveloped (Caballero 2003). Another way for international financial institutions to con-

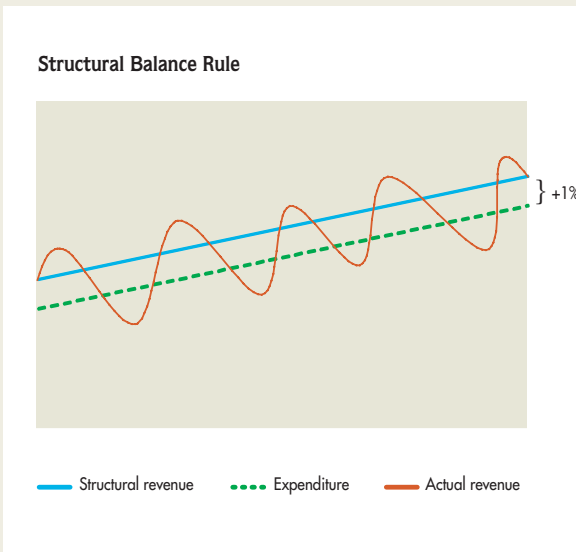
⁵⁰ The conclusion is unchanged if pensions are excluded. Latin American average social spending excluding education and pensions is 4.8 percent of GDP, compared with a range of 9.4 percent (United States) to 24 percent (Sweden) in OECD countries.

Box 8.6 The Chilean Structural Balance Rule

Chile introduced its Structural Balance Rule (SBR) in 2000, when, for the first time in 20 years, the government was running a budget deficit. The main stated objective of this rule was to ensure a fiscal surplus of 1 percent of GDP in the medium run.¹

The objectives of the rule were to introduce automatic stabilizers to fiscal policy, reducing the degree of procyclical fiscal policy and therefore the impact of external shocks on output and employment. A second stated objective was to improve the credibility of fiscal policy, which should in turn reduce financing costs and assure stable access to international financial markets.

The Chilean SBR is based on the IMF and OECD methodologies for calculating structural balances in devel-



oping economies, and published in IMF (various years). There are two main differences. The first is that the accounting principle is changed from one of “public sector financing needs” to that of “net equity changes.” Specifically, income from privatizations is subtracted and income accruing to the copper and oil stabilization funds is added. Second, the cyclical component is only removed from income and special consideration is given to the price of copper.

Structural income (that is, without the cyclical component) is the sum of two structural components: tax income adjusted for cyclical variations in output around potential GDP and copper income adjusted for the cyclical variations in the price of copper around a long-run trend. The two key variables for this calculation are therefore the estimates of potential GDP and the long-run reference price for copper. How well the SBR operates will depend crucially on the accuracy and credibility of these estimates. Systematic overestimation of any of these variables will generate a deficit bias and erode credibility. To ensure independence, the Chilean authorities have delegated estimation of potential GDP and the reference price of copper to a panel of economists from various public and private institutions.

Expenditure is set so as to generate a 1 percent surplus with respect to structural income (see the figure). In periods of low growth (below the potential growth rate) or low copper prices (below the reference price), the realized surplus will be less than 1 percent. The result is a countercyclical fiscal policy that should generate a 1 percent surplus in the medium run.

¹ See “Balance Central del Gobierno Estructural: Metodología y Estimaciones para Chile: 1987-2000” at http://www.dipres.cl/publicaciones/Balance%20MH_1.html.

tribute to improve creditworthiness during recessions and limit higher spending during expansions is to make sure that disbursement of funds is more countercyclical, although this proposal is fraught with moral hazard problems.

Financing Countercyclical Fiscal Policies

Crises are common and recessions are deep in Latin America, and the poor and middle-income brackets are negatively affected. The procyclical behavior of fiscal policy—apart from increasing

economic volatility—is a constraint on the ability of Latin American governments to protect the population from the risks of job churning. Efforts must be made to increase savings during expansions, access to credit during recessions, and the size of automatic stabilizers in the budget.

Simplistic applications of general principles, such as “make budget procedures more hierarchical” or “implement fiscal rules to limit spending and deficits” do not necessarily result in better fiscal outcomes. A more detailed, country-specific analysis is required to match detailed proposals to

specific political contexts. This type of analysis is in its early stages, and international financial institutions should expand their efforts to enhance the knowledge about the particular mechanisms of operation in this area.

Voluntary approaches to fiscal rules and stabilization funds should be avoided; evidence shows that they do not work. More research is needed regarding what works in different political and economic environments. The same applies for reform of budget institutions. Probably hierarchical and transparent procedures would be good, but more country-specific analysis is needed on how to implement these broad ideas. It is clear that incentive problems with subnational spending are important. However, the cases studied by Dillinger, Perry, and Webb (2001) seem to indicate that easy solutions, such as stabilizing transfers, do not necessarily work. On the bright side, there are some encouraging experiences in the region, such as the

Fiscal Responsibility Law in Brazil and the structural surplus rule in Chile (see Box 8.6).

In the long run, Latin American countries would likely benefit from a more developed welfare state, both through greater macroeconomic stability and less risk for the population from aggregate shocks. A step in the right direction would be for central banks and technical offices to actually start calculating the cyclical component of fiscal policy. However, the road in this direction is long. It will require “brilliant fiscal management” (Birdsall 2002), more trust of citizens in government, and more transparency and accountability. Automatic stabilizers, such as unemployment insurance, can be risky in a context of low transparency and state capacity, and it might be impossible to cut spending during booms if the government cannot control whether unemployment insurance beneficiaries are employed in the informal sector.