



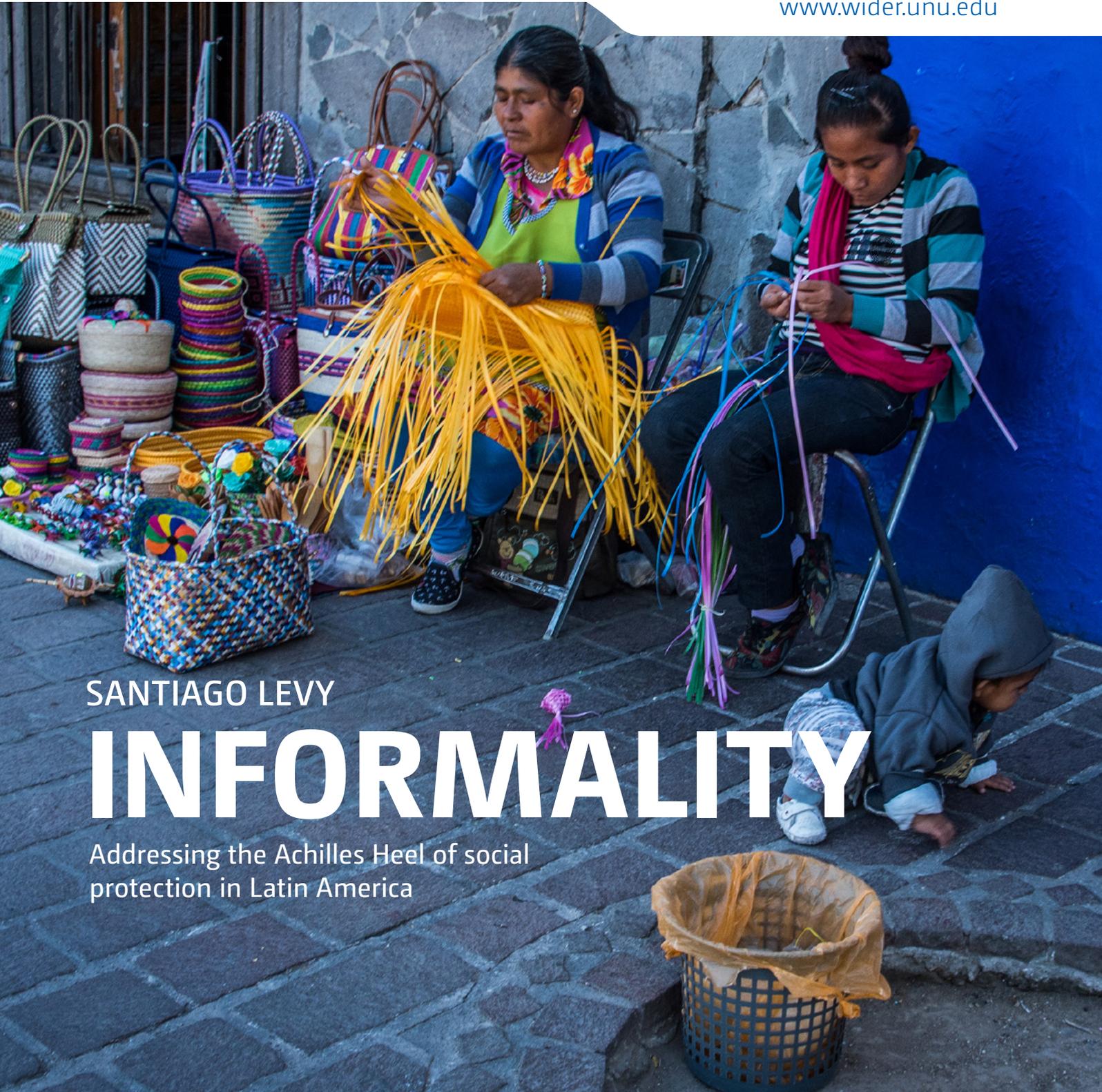
UNITED NATIONS
UNIVERSITY
UNU-WIDER

WIDER

Annual
Lecture

23

www.wider.unu.edu



SANTIAGO LEVY

INFORMALITY

Addressing the Achilles Heel of social
protection in Latin America

UNU-WIDER BOARD

Chair

Professor Benno Ndulu
University of Dar-es-Salaam

Members

Professor Ann Harrison
University of California

Professor Justin Lin
Peking University

Dr Jo Beall
British Council

Professor Martha Chen
Harvard Kennedy School

Professor Miguel Urquiola
University of Columbia

Professor Haroon Borat
University of Cape Town

Ex officio

Dr David M. Malone
Rector of UNU

Professor Kunal Sen
Director of UNU-WIDER



© Gerardo Pesantez

Contents

See more



© UN Photo / Ted McGrath

The United Nations University World Institute for Development Economics Research provides economic analysis and policy advice with the aim of promoting sustainable and equitable development for all. The Institute began operations over 30 years ago in Helsinki, Finland, as the first research centre of the United Nations University. Today it is a unique blend of think tank, research institute, and UN agency – providing a range of services from policy advice to governments as well as freely available original research.

United Nations University World Institute for Development Economics Research (UNU-WIDER) gratefully acknowledges the support of the governments of Finland, Sweden, and the United Kingdom to its 2019–23 work programme.

UNU-WIDER
Katajanokanlaituri 6 B
00160 Helsinki, Finland

Copyright © UNU-WIDER 2021

Typescript prepared by Lorraine Telfer Taivainen.

The views expressed in this paper are those of the author(s), and do not necessarily reflect the views of the Institute or the United Nations University, nor the programme/project donors.

ISSN 1455-3082 (print)
ISSN 1564-8311 (online)

ISBN 978-92-9256-960-0 (print)
ISBN 978-92-9256-959-4 (online)

| | |
|---|--------------------------|
| 2 | Foreword |
| 3 | Author's acknowledgments |
| 3 | About the author |

| | |
|----|--|
| 4 | 1. Introduction |
| 6 | 2. Social insurance and social assistance |
| 8 | 3. Bismarck's inheritance |
| 12 | 4. Non-contributory programmes to the rescue? |
| 16 | 5. Putting the pieces together |
| 18 | 6. Interface between social insurance and social assistance programmes |
| 20 | 7. The case for universal social insurance |



© Curt Carnemark



Foreword

Over the past decades, social protection policy has emerged as a new paradigm in the fight against poverty and vulnerability in the Global South. It has become a crucial component of development policy, bolstering economic processes and protecting the gains countries make from external shocks and macroeconomic risks. The evolution of deeper and broader social protection systems everywhere in the world is an unprecedented development with great promise for improving wellbeing. But developing functioning social protection systems that leave no one behind is not without several challenges particular to the developing world.

This is why we were delighted when Santiago Levy accepted our invitation to give the WIDER Annual Lecture on 'Informality: Addressing the Achilles heel of social protection in Latin America'. Santiago's wisdom and experience in this area offers deep and important insights for those of us working in the area of social protection.

Each year the WIDER Annual Lecture is delivered by an eminent scholar or policy maker who has made a significant and widely recognized contribution in the field of development. The lecture is a high point in the institute's calendar. Santiago Levy – an economist with a long history of experience in public policy – is a perfect addition to the esteemed list of lecturers UNU-WIDER has presented since the series began in 1997.

Santiago Levy is one of the principal architects of Mexico's Progresa-Oportunidades, a major social assistance programme that helped to inspire a new generation of targeted social policy across the developing world, but particularly in Latin America. The incentive-based programme paved a path towards social protection packages across Latin America that helped it to become the only major world region to have broadly reduced inequality post-2000. As a member of Mexico's Ministry of Finance and Social Security Institute from 1994–2005, his public service record also includes work on decentralizing resources to states and municipalities, transitioning from general to targeted subsidies, reforms of the Mexican pension system, and overseeing provision of health services to 45 million people.

Acknowledgement

Based on the UNU-WIDER Annual Lecture given in Geneva, Switzerland on 30 October 2019. The author expresses his gratitude to Kunal Sen for his kind invitation to deliver the lecture.

Progresa-Oportunidades's 'human development' approach became a precursor to other conditional cash transfer programmes, and country after country adopted similar programmes, realising the importance of providing social protection for the poor. Progresa-Oportunidades, along with Bolsa Familia in Brazil, were the landmark social protection programmes that had huge legacy effects, and Santiago Levy was very much instrumental in popularising these programmes in the developing world.

In more recent writings, Santiago has turned his attention to understanding the poor economic performance of Mexico in recent decades, in spite of impressive macroeconomic stability and close integration into the world economy. In his recent book, *Under-Rewarded Efforts: The Elusive Quest for Prosperity in Mexico*, using very rich data and meticulously done empirical analysis, he shows that different facets of Mexico's policy environment – social insurance mechanisms, tax policies, poor contract enforcement – led to poor microeconomic incentives that taxed the high-productivity formal segment of the economy while subsidising the low-productivity informal segment, leading to low economy-wide productivity growth. In the Annual Lecture, Santiago Levy brings together his earlier interest in social protection and his more recent interest in informality.

In his preface to Santiago's book, Dani Rodrik of Harvard University writes 'when sound economics is combined with a practical, pragmatic bent, it can be a potent force for good. There are very few people who are as good a living embodiment of this as Santiago Levy'. This Annual Lecture is testament to Santiago Levy's unique ability to combine academic rigour with policy relevance. In its entirety, the lecture reveals major limitations in existing social protection systems and stands as a uniquely pragmatic set of guidelines to improve social protection systems in the developing world. Santiago Levy's contribution here is immeasurably useful in its approach and makes a compelling case for systems that provide fully universal social insurance.

Kunal Sen
Director UNU-WIDER
Helsinki

About the author

Santiago Levy is currently Senior Fellow at the Brookings Institution and Senior Advisor with the United Nations Development Programme. Previously he was Vice President of the Inter-American Development Bank, and President of the Latin American and Caribbean Economic Association. In Mexico he was Director General of the Social Security Institute, Deputy Finance Minister, and President of the Federal Competition Commission. He was the principal promoter of Mexico's Progresa-Oportunidades programme. Prior to that he was Associate Professor of Economics at Boston University and Director of the Institute for Economic Development. He has been awarded first place in the National Prize of Economics. He has published extensively in the areas of growth, productivity, education, labour markets, poverty, social protection, and development in general. His latest book is *Under-Rewarded Efforts: The Elusive Quest for Prosperity in Mexico*.

1

Introduction

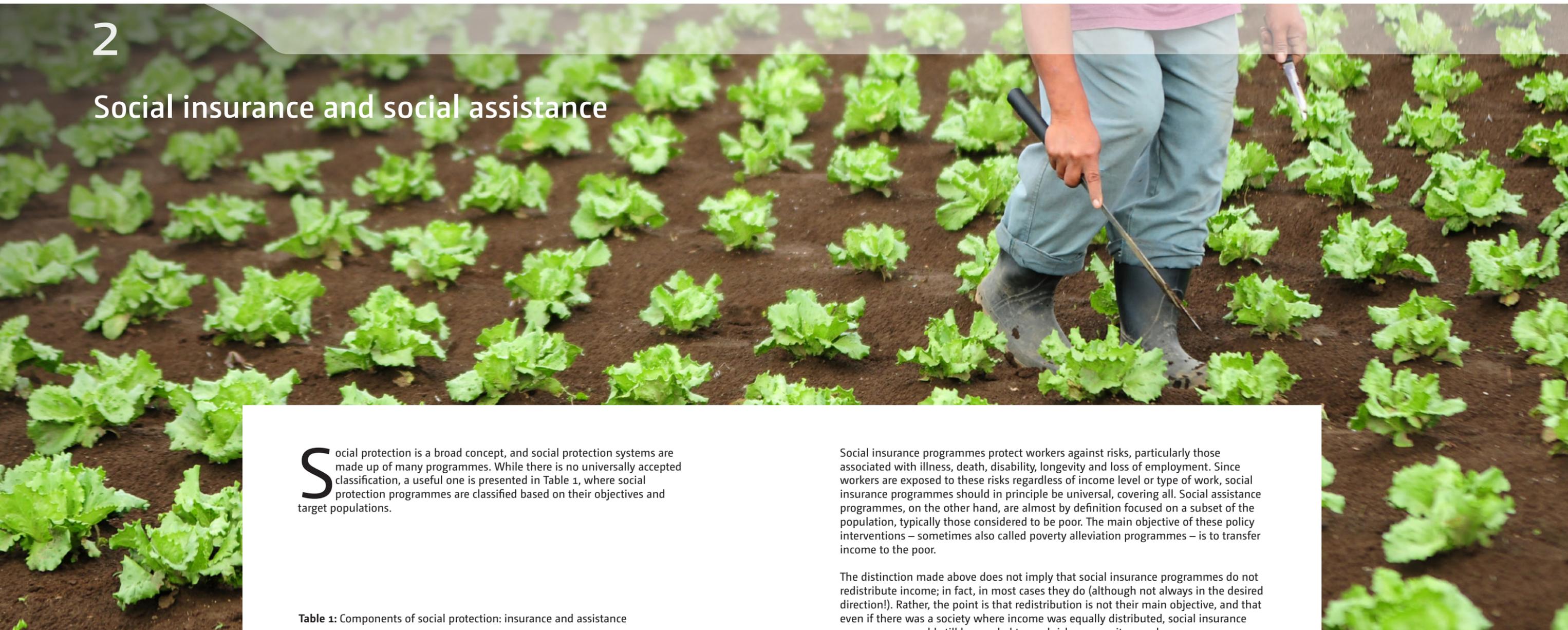
On 11



Social protection systems are an essential ingredient for socially inclusive growth, the central objective of policy makers in most developing countries. To contribute to this objective these systems need to have broad coverage and deliver quality services. They also need to be sustainable, both in the sense of being within countries' fiscal means, and in the sense of facilitating growth. Designing social protection systems that comply with these requirements is a major challenge, and indeed few developing countries can boast complete success. This lecture discusses some dimensions of this challenge in countries characterized by large informality, which is the situation prevalent in most countries in Latin America (henceforth, LA), a region where more than half of the labour force is informal.

2

Social insurance and social assistance



Social protection is a broad concept, and social protection systems are made up of many programmes. While there is no universally accepted classification, a useful one is presented in Table 1, where social protection programmes are classified based on their objectives and target populations.

Table 1: Components of social protection: insurance and assistance

| | |
|---|---|
| Objectives and target population | Social insurance programmes |
| All households | (Health, life, disability and unemployment insurance; retirement pensions; other) |
| Redistribution | Social assistance programmes |
| Households living in poverty | (Cash transfers; food subsidies; school breakfast; other) |

Social insurance programmes protect workers against risks, particularly those associated with illness, death, disability, longevity and loss of employment. Since workers are exposed to these risks regardless of income level or type of work, social insurance programmes should in principle be universal, covering all. Social assistance programmes, on the other hand, are almost by definition focused on a subset of the population, typically those considered to be poor. The main objective of these policy interventions – sometimes also called poverty alleviation programmes – is to transfer income to the poor.

The distinction made above does not imply that social insurance programmes do not redistribute income; in fact, in most cases they do (although not always in the desired direction!). Rather, the point is that redistribution is not their main objective, and that even if there was a society where income was equally distributed, social insurance programmes would still be needed to pool risks among its members.

Aside from having different objectives and target populations, social insurance and social assistance programmes differ in their legal status – while there is variation across countries, typically the former are legislated as a right of workers; however, this is usually not the case with the latter. Another relevant distinction relates to the time dimension – workers should be permanently covered by social insurance programmes since they are always exposed to risks, such as illness or death. On the other hand, social assistance programmes should in principle be transitory, in the sense that ideally poor workers will earn higher incomes during their lifetime and will no longer need to receive transfers from the government.

Importantly, the fact that poor workers benefit from social assistance programmes does not eliminate their need for social insurance. These workers face the same risks that non-poor workers face. A well-designed social protection system should have universal coverage of most, if not all, social insurance programmes and, for the poor, complementary benefits through social assistance programmes. At times universalism and targeting are presented as distinct approaches to social protection; in my view, they are complementary. It should also be pointed out that it is a major mistake to think that social insurance programmes are only for the non-poor and social assistance for the poor. Or to think that there should be separate social insurance programmes, again one for the poor and another for the non-poor.

3

Bismarck's inheritance



In most LA countries access to social insurance programmes depends on workers' status in the labour market. This creates substantive issues for the population covered; the type of risks against which workers are protected; the fairness of the system; its fiscal sustainability; and the behaviour of firms and workers in reaction to these programmes, with spillover effects on productivity and growth.

Although institutional differences matter, most countries in LA distinguish between salaried and non-salaried workers (at times called dependent and non-dependent). Salaried workers have a boss (a firm) and receive a salary in return for their efforts: a monetary remuneration per unit of time worked, paid with a fixed periodicity independently of the level of production or sales. This is very important, as these payment flows can be easily observed and measured, and therefore taxed.

Non-salaried workers, on the other hand, are a varied lot. Some work on their own, but others can be associated with a firm although not in a subordinated position. Their earnings take many forms. When workers are self-employed, they capture all the surplus of their activity; when they are associated with a firm, they can be paid a commission based on the number of units sold or produced, or through profit-sharing arrangements. In other cases, workers are relatives of each other in a small enterprise (the traditional family firm), where the surplus is divided following cultural norms. Critically, the unifying feature of all these workers is that none are paid a salary. Their earnings are more difficult to observe and measure than those of salaried workers, and are also more volatile, making them more difficult to tax.

The distinction between salaried and non-salaried workers is central because the laws in LA countries obligate firms to only enroll their salaried workers with social insurance institutions. There are many reasons for this. The first is associated with the European origin of social insurance, based on the ideas of the German Chancellor Bismarck at the end of the nineteenth century. At that time, social insurance was conceptualized as a responsibility of firms, which were obligated to pay ear-marked taxes, labelled social insurance contributions, proportional to the salaries (or wages) paid to their workers. These contributions, channeled into common funds, would pool risks and insure workers against various contingencies. A second reason is that it was thought that by making firms pay these contributions, income would be redistributed from, broadly speaking, capital to labour. In this context, the fact that wages could be easily observed substantially facilitated the implementation of the overall scheme, which later came to be known as contributory social insurance (although a better name would be wage-based social insurance, or social insurance contributed from a tax on wages).

There is substantial variation among countries as to the programmes included in contributory social insurance. It usually includes health, life and disability insurance, and retirement pensions. However, some countries have additional programmes: Colombia for labour training; Argentina for child allowances; and Mexico for day care services and housing. That said, one very important item is usually excluded —



© Jerry Frank

unemployment insurance. This because in most LA countries, protection against the loss of employment takes the form of stringent regulations on dismissal and severance pay, which are usually classified as 'labour regulations' and often excluded from discussions of social insurance. In my view this is a mistake. These regulations are intended to protect workers against risks, just as the other components of social insurance do.

Social insurance programmes started in LA in the 1930s and 1940s based on the Bismarckian model, and were expected to be the cornerstone of these countries' social protection systems. Nevertheless, more than three-quarters of a century later, it is fair to say that they have fallen substantially short of their expectations. There are four major shortcomings.

3.1 Limited coverage

In LA as a whole only about 44 per cent of the labour force is covered.¹ Many reasons stand behind this disappointing outcome, but two stand out. First, salaried contractual relations do not extend to the whole economy. Second, evasion by firms of their social insurance obligations. Indeed, the large proportion of workers excluded from contributory social insurance is what gives rise to the ubiquitous informal employment that characterizes LA.

Importantly, informality is defined here with respect the coverage of social insurance regulations, not the payment of taxes. This makes a distinction between informality and illegality, and highlights that not all informality results from imperfect enforcement of social insurance laws. Indeed, even if these laws were perfectly enforced there would still be informal employment, as some workers – all non-salaried ones – would be excluded from coverage. Differently put, exclusion is an inherent feature of contributory social insurance; no amount of enforcement will eliminate it completely and deliver universal coverage.

3.2 Under-valuation of benefits

Firms evade social insurance contributions for two reasons. One is that these contributions are bundled with regulations on dismissal, minimum wages, and union rights; and with firms' obligations to withhold workers' income taxes that only apply to salaried workers. In effect, when firms evade social insurance contributions, they are evading all the regulations imposed on salaried contracts, not only those relating to social insurance. The second reason is that contributions are undervalued by workers because the quality of services provided is often poor (particularly in the case of health, where services are usually delivered by public sector monopolies); or because some benefits, such as retirement pensions, are too distant in the future and workers have high discount rates; or because some benefits are not relevant to some workers (such as day care centers). Whatever the reason, the result is that workers consider that what they, and the firms that hire them, pay for social insurance, exceeds what it is worth to them. The critical implication is that contributory social insurance de facto acts like an implicit tax on salaried employment; a tax which, like any other, will be evaded whenever possible.

3.3 Transits between labour status

The third shortcoming derives from a critical yet underestimated feature of labour markets in LA — the fact that workers move continuously between salaried and non-salaried status; and when salaried, between firms that comply with social insurance laws and firms that do not. In alternative language, workers transit between formal and informal status. Employment surveys following individual workers over a period of time show that these transits are intense. In Brazil, 19 per cent of workers who start the year in an informal job end up in a formal job by the end of the year, while 10 per cent who start in a formal job finish in an informal one. For Colombia the respective numbers are 13 and 17 per cent, and for Argentina 11 and 8 per cent. Similar figures are obtained for Peru, Ecuador and Paraguay (while for other countries no data is available).

¹ Though there is considerable variation. Chile, Costa Rica, and Uruguay have coverage rates of around 70%; Bolivia, Paraguay and Peru of less than 30%. But even large middle-income countries like Colombia and Mexico have coverage rates of 35 and 40%, respectively.

Many reasons stand behind these transits. Some legally-hired salaried workers might want to try their luck working on their own, or start their own firm, transiting from formal to informal status. Others might lose their job because the firm that employed them went bankrupt. While others still might continue to work in the same firm, but change status because the firm hiring them decided to break the law (so that some formal – informal transits might imply a change of status but not of job). Similarly, non-salaried workers employed in a small family firm might decide to work as salaried workers in a large formal firm, or may move from rural areas, where formal jobs are scarcer, to urban areas, where they are relatively more abundant.

Voluntary or involuntary, these transits diminish substantially the efficacy of social insurance. In the end, workers can get ill or suffer an accident when they formally or informally employed but are only protected against these risks in the first case. It is as if one purchased fire insurance for a house, or accident insurance for a car, that covered these contingencies only during winter and fall, but not during spring and autumn; clearly, such erratic coverage is unsatisfactory. Indeed, this erratic coverage is yet another reason why workers undervalue the benefits of contributory programmes. Quite simply, workers do not know when they are going to get sick, or experience an accident or, worse still, die. They need to be protected all the time, independently of the vagaries of the labour market.

Transits are harmful to retirement pensions. Regardless of whether pensions schemes are defined benefit or defined contribution, workers only accumulate rights and save for their pension when they are formal. Data for Mexico, for instance, shows that workers are formal on average about half of the time that they are employed, and therefore save for their pension only half of the time that they could. As a result, when they retire, their pensions will replace a small portion of their salary (less than 30 per cent versus over 70 per cent in most OECD countries). Moreover, many will not qualify for a pension because they will not accumulate the required years (24) of contribution. Worryingly, two out of every three workers contributing for their pension in Mexico's defined contribution system will not qualify for a pension! Similar situations apply in Colombia, Peru, and Bolivia.

3.4 Impacts on productivity

Lastly, the fourth shortcoming of Bismarckian social insurance relates to its impact on productivity. The implicit tax on salaried labour induces firms to change the contracts offered to workers from salaried to non-salaried. This may diminish productivity because non-salaried contracts may not be the most appropriate from the point of view of firms' business model or production technology, but firms might find it profitable to do so anyway if the cost savings compensate the productivity losses. Alternatively, firms may continue to offer their workers salaried contracts but decide to evade the contributions. However evasion is not free, since firms might be caught and fined. To minimize that possibility, firms will oftentimes remain small; and while this may be a successful evasion strategy, it will be costly in terms of productivity as firms fail to exploit economies of scale and scope, or take advantage of transitory business opportunities. In parallel, their illegal status might close off access to commercial bank credit, restricting their options to more costly credit from suppliers' or the local money lender.

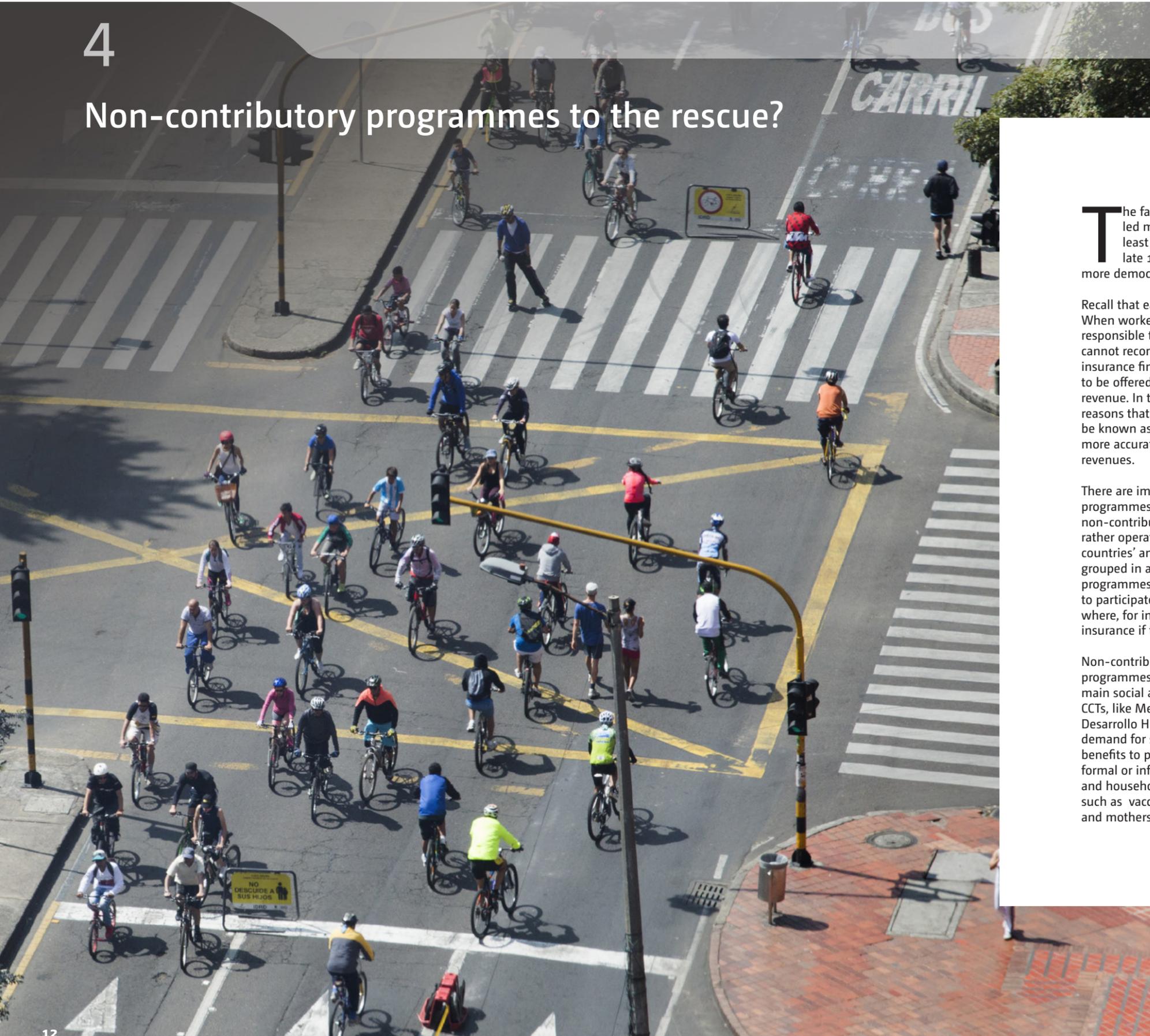
There are many reasons for the prevalence of very small firms in LA related to taxation, contract enforcement, and conditions of access to credit — but a malfunctioning contributory social insurance system is one of them, since the implied taxes on salaried labour can be large. And while smallness might be a profit-maximizing firm strategy in these contexts, workers suffer from it. Small firms are more fragile to shocks and fail more often than larger ones; they also invest less in training and use less sophisticated technologies. Workers in these firms have erratic and short-lived jobs, with few opportunities for on-the-job learning and skill acquisition. As a result, workers transit from bad jobs in small informal firms sometimes to self-employment or to equally bad jobs in other small informal firms. Persistently low-productivity jobs result in flat earnings profiles as workers have few opportunities to learn new skills and become more productive during their life-cycles.



© Mark Garten

4

Non-contributory programmes to the rescue?



The failure of Bismarckian social insurance, particularly with regard to coverage, led many LA governments to search for alternatives to offer informal workers at least some of the benefits received by formal ones. This search took off in the late 1980s and early 1990s, not uncoincidentally with the transition towards more democratic and less authoritarian forms of government.

Recall that earnings of non-salaried workers are difficult to observe and measure. When workers are self-employed, there is no firm that can be made legally responsible to enroll workers with social insurance institutions. In other cases, the firm cannot record wages paid, since in fact there are none. Evidently, in these cases social insurance financed through ear-marked wage-based taxes cannot exist. If benefits are to be offered to informal workers, they must be financed from an alternative source of revenue. In this context, the most common source was general public revenues. For reasons that I ignore, the programmes financed under this mechanism have come to be known as non-contributory programmes, although of course this is a misnomer. A more accurate label would be social insurance programmes contributed from general revenues.

There are important differences between non-contributory and contributory programmes. First, as noted, their source of finance differs. Second, in many cases non-contributory programmes are not a legal right or entitlement of workers, but rather operate as self-standing programmes included in a somewhat ad hoc way in countries' annual budgets. Third, non-contributory programmes are not bundled or grouped in a package as are contributory ones; instead, there is an offer of various programmes 'out there' from which workers can choose to benefit, but without having to participate in all of them at the same time (as opposed to contributory programmes where, for instance, workers are obligated to save for retirement and purchase life insurance if they are to have access to health insurance).

Non-contributory programmes should not be confused with social assistance programmes. As mentioned, the latter programmes are targeted on the poor. The main social assistance programmes in LA are conditional cash transfer programmes, CCTs, like Mexico's Progres- Oportunidades, Brazil's Bolsa Familia, Ecuador's Bono de Desarrollo Humano or Colombia's Familias en Acción. These programmes subsidize the demand for schooling and for primary health services. They do so delivering monetary benefits to poor households — regardless of whether workers in the household are formal or informal — conditional upon children's and youngsters' school attendance, and household members attendance to primary health clinics for simple interventions, such as vaccinations, treatment of diarrhea, and nutritional supplements for children and mothers.



© Gerardo Pesantez

There is substantial overlap between workers that are informal and workers that are poor, inducing the conflation between social assistance programmes and non-contributory social insurance programmes that one notices in policy discussions (and sometimes in the academic literature), all under the rubric of 'social protection'. But it is essential to separate them. On one hand, the objective of CCTs is to invest in the human capital of the poor, while the objective of non-contributory programmes is to provide insurance to households excluded from contributory programmes. On the other, CCTs try to change the behaviour of parents vis-à-vis the allocation of children's time between schooling and income-generating activities (and themselves between investing time in their health and dedicating it to other endeavors); non-contributory programmes mostly affect the behaviour of workers and firms in the labour market in terms of the type of jobs that are offered and sought.

There is substantial variation in the quality and scope of non-contributory programmes in LA. Argentina offers the same child allowances to informal workers that it provides to formal ones; Mexico offers day care services to informal workers, but of lower quality than for formal ones. That said, most non-contributory programmes focus on health and retirement pensions. Health services are usually of lower quality than those provided to formal workers (but the gap is closing). Retirement pensions, on the other hand, are almost always a flat amount; this in contrast to contributory pensions, where pensions bear some proportionality to previous wages. Importantly, this feature implies that non-contributory pensions are more important to low-income than high-income workers.

Non-contributory programmes usually extend to illegally hired salaried workers. Even though these workers should in principle benefit from contributory programmes, the behaviour of the firm hiring them impedes this from happening. But the firm's illegal behaviour does not diminish the worker's need for protection against illness and other risks, which is then provided by non-contributory programmes. Differently put, these programmes benefit all informal workers, regardless of whether their condition of informality results from their non-salaried status, or from firms' evading behaviour.

From a social point of view, non-contributory programmes are clearly welcome. Through them, many workers who would lack a pension when they retire will have one, reducing old-age poverty. Similarly, through them, informal workers have access

to health services that include hospitalization and attention to illnesses that are costly to treat. And while there may be shortcomings in quality versus contributory programmes, it is better to have some benefits than none. Further, non-contributory programmes can help to reduce income disparities, since informal employment is more prevalent among low-income households. Finally, while these programmes may have a lower legal standing than contributory programmes since they are not entitlements, they certainly enhance social protection.

Non-contributory programmes impact the behaviour of workers and firms. Consider a firm hiring a salaried worker. In the absence of these programmes, if the firm evades social insurance contributions, workers are left without benefits. The firm will decide to evade or not based on the probabilities of being detected and fined; and workers may decide to go along or not with the firm's evasion decision based on the size of the wage adjustment experienced if the firm evades. However, non-contributory programmes change this calculus. While the probabilities of detection are the same, the benefits of evading are not. If firms evade, workers receive some social benefits for free. Clearly, evasion is more profitable, and more of it will occur. Inadvertently, non-contributory programmes end up subsidizing firms' illegal behaviour. And aside from the fact that workers' rights are being trampled by this situation, illegality will further hurt workers. The firm will grow less to avoid detection and will have reduced access to commercial bank credit and so on, hurting workers because they are employed by smaller and more fragile firms that are less likely to invest in their training and provide them with longer-lived jobs.

Non-contributory programmes subsidize all forms of informal employment, not only illegal ones. The calculus of a worker considering working on his own will also change. In the absence of these programmes, the benefits of self-employment to a worker are only their earnings (ignoring the non-pecuniary benefits of not having a boss and having flexible working hours); with non-contributory programmes, the benefits now include free health services and a pension in the future. Clearly, the utility of self-employment increases. The argument extends to other forms of non-salaried employment. The members of a small family firm will only share the surplus of the operation in the absence of non-contributory programmes, but in their presence will share the same surplus and in addition enjoy free health benefits, perhaps access to day care services or child allowances, and eventually enjoy a pension without being forced to save for one.



© Maria Fleischmann

Of course, subsidizing informal employment is not the intention of non-contributory programmes, but it is nonetheless the unavoidable result of programmes that provide free benefits conditional on not having a formal job. Since the productivity of economic activity in the informal sector is on average lower than in the formal one, these programmes will also inadvertently lower the productivity of the economy. Note that this effect is additional to the implicit tax on salaried workers associated with undervalued contributory programmes. In effect, reduced formal employment and higher informal employment result from two distinct but complementary mechanisms: first, because malfunctioning contributory programmes tax salaried labour; and second, because non-contributory programmes subsidize non-salaried and illegal salaried labour.

5

Putting the pieces together

The relevance of the arguments made earlier varies across LA countries, since there are differences in the design and functioning of institutions, the forcefulness with which social insurance laws are enforced, the bundling of contributory benefits, contribution rates, the type of retirement pension regimes, the quality of health, day care and other services, as well as the relevance, scope, quality and targeting rules of non-contributory programmes. In addition, countries differ in their rules on dismissal, minimum wage and other regulations bearing on the functioning of the labour market, and on the degree of workers' mobility across labour status. Thus, the arguments made before should be seen as a broad canvass, not as a detailed picture of any country, and many nuances and qualifications need to be brought in as these arguments are considered in the light of a specific country.

That said, what is important is to have an overall view of the different pieces of the system — all contributory and non-contributory programmes — and of their interactions. The broad picture that emerges is far from satisfactory. From the social point of view, social insurance systems at best do a mediocre job protecting workers from risks: coverage is incomplete and erratic. And from an economic point of view, they induce distortions that are very costly in terms of productivity, growth and workers' access to good jobs.

© Curt Carnemark

6

Interface between social insurance and social assistance programmes

As mentioned, CCTs — the main social assistance programmes in LA — invest in the human capital of the poor, under the expectation that these investments will in the future translate into more productive jobs with higher earnings. Also as mentioned, resources are more productive in the formal than in the informal sector, so a better job is usually a formal job. Thus, with the help of CCTs, poor workers should transit from informal to formal jobs, breaking the intergenerational transmission of poverty.

The segmentation of social insurance into contributory and non-contributory segments is a major obstacle in this process. These programmes tax formal employment and subsidize informal employment, exactly the opposite of what is needed to help poor workers get better jobs. Worse still, at times these taxes and subsidies are higher for poor than for non-poor workers. The tax is higher because usually health facilities from contributory programmes are of lower quality in localities where the poor live (rural areas and urban slums); because they transit more across labour status and are less likely to get a contributory pension; and so on. And the subsidy is higher because often there is an express objective of setting up non-contributory health programmes in the localities where contributory programmes are absent, or because, as noted, a flat non-contributory pension will be more meaningful for a poor than a non-poor worker.

There is thus a problem of incentive compatibility between social insurance programmes and CCTs. The latter invest in the human capital of the poor; the former make it difficult for the poor to cash in on these investments. A relevant example is provided by Mexico. Partly as a result of Progresas-Oportunidades, between 2005 and 2019 poor workers increased their schooling by 28 per cent, from 7 to 9 years; yet, during the same period their rate of informal employment actually increased, from 80 per cent to 83 per cent.

© Maria Fleischmann

7

The case for universal social insurance



© Igor Castro da Silva Braga

These arguments are the basis of a call for universal social insurance. Of course, such a call is a tall order. Reaching universal social insurance is a complex process and countries in LA will not achieve it immediately. But such a call is critical, in recognition that the current combination of contributory and non-contributory programmes is clearly undesirable, and as a broad guidepost of where policy needs to aim at. Yes, the current combination is better than nothing, but I believe we would be wrong defending the status quo as the desirable long-term equilibrium. And we may be kidding ourselves if we think that it is fiscally sustainable.

There are many variants of universal social insurance, depending on what is included in its definition. In my view, five components should be provided by a well-functioning system, protecting workers against five risks: illness, death, disability, longevity, and involuntary loss of employment. However, not all components should be aimed at all workers. In fact, this is a useful guiding principle: all workers should be protected against risks that are independent of the type of labour contract; in addition, workers in a labour contract with risks specific to that contract should also be protected from those risks.

The salaried and non-salaried distinction is critical here. Clearly, all workers regardless of whether they work on their own, or in a salaried or non-salaried relation with a firm, can get sick. The same is true of sudden death or disability. And it is equally clear that all workers face the risks of longevity, since regardless of how they participate in the labour market they do not know when they are going to die. But the same is not true of involuntary unemployment: in this case, workers have to be in a salaried relation with the firm for them to be fired. Put differently, in an ideal system all workers would be covered by health, disability and life insurance, and have access to mechanisms to help them deal with longevity risks. In addition, salaried workers should also have access to unemployment insurance. By de-linking most components of insurance from workers' labour status, workers would be protected from the main risks all the time, in principle with the same coverage, thus substantially increasing the efficacy of insurance.

Critically, the financing of the common components of social insurance should not discriminate between salaried and non-salaried status. Aside from providing the same coverage against risks, a well-functioning and sustainable system must also eliminate the implicit tax on formal employment and the subsidy to informal employment. Differently put, a well-functioning system should not only provide coverage to all, it should also be conducive to growth. Thus, universal has a double meaning: same benefits, and same sources of funding.

Two observations are useful here. First, there are many variants and institutional arrangements on how benefits can be provided. There is no universal recipe or one-size-fits-all mechanism, and countries' administrative and institutional capabilities,

particularly with regard to taxation and its enforcement, are central to determine the best way to provide them.

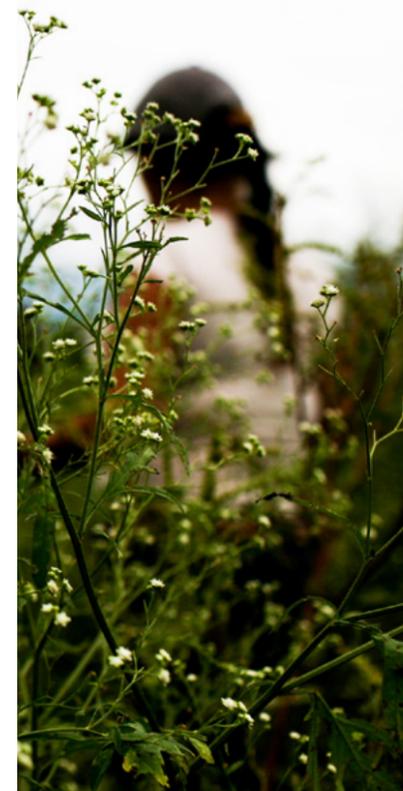
Second, universal coverage against common risks should be seen as the outcome of a gradual effort, and it may not be possible to advance with equal speed in all cases. As a result, it is essential to have a view of the relative importance of each risk. In my opinion, advancing towards universal health insurance should take priority, for various reasons. First, because of the inefficacy of the current arrangements from the point of view of social welfare. Second, because some illnesses can be so costly to attend that, in the absence of insurance, they may bring families to ruin. Third, because universal health insurance would probably remove the largest component of the distortion in the labour market associated with the existing contributory/non-contributory dichotomy. And fourth, because it would contribute importantly to lower inequality, since high-income and low-income workers would receive freely the same health services.

Advancing towards universal health insurance, fully funded from general revenues and with services provided – as Beveridge¹ would say, 'free at the point of delivery' – should be in my opinion the first priority in the march towards universal social insurance. That said, countries need to also tackle pensions. One possibility here is to extend to everyone the basic non-contributory pensions currently offered only to informal workers. On the one hand, this would eliminate the disincentive to save for retirement through the contributory system, as all workers would receive the same non-contributory pension regardless of their formal or informal participation. On the other, it would increase the replacement rate those for workers that do get a contributory pension, particularly in the lower segments of the wage distribution, as the non-contributory pension is added to the contributory one. Another possibility is to collect the contribution for a retirement pension for non-salaried workers along with their payments for personal income taxes. This would force all workers to save for a contributory pension regardless of their form of employment, increasing contribution densities and replacement rates.

Undoubtedly, most options would require additional fiscal resources, a non-trivial issue in LA. Four points can be made here. First, those fiscal efforts would be rewarded by a significantly strengthened and more redistributive social insurance system; and a more inclusive society. Second, their net fiscal cost will be lower, as the incentives to evade and, more generally, the incentives to engage in low-productivity informal activities are diminished and resources shift into higher productivity formal ones. Third, not all these actions need to be undertaken at the same time; they can be introduced gradually to lower their fiscal cost. And fourth, countries would have social insurance systems that are incentive-compatible with their social assistance systems, a critical point when thinking about poverty.

The larger point to be made, however, has to do with the broader direction of social protection policy. It probably matters less how fast policies are introduced, than ensuring that the right policies are introduced. Social insurance policy in LA has suffered from the absence of a holistic vision of the interactions between its various programmes; and in turn on how these programmes impact and are in turn influenced by the dynamics of the labour market. As a result, many well-intended but isolated non-contributory programmes (such as new health and day care programmes, child allowances, and so on) as well as isolated reforms of contributory programmes (of pensions, of health, and so on), have resulted in contradictory outcomes. The result has been, *mutatis mutandis* as we consider various countries, the current constellation of contributory and non-contributory programmes, with their contradictory effects on welfare, inequality, productivity and growth; complemented by social assistance programmes, in the form of CCTs or other, whose effectiveness is reduced given their interface with social insurance programmes.

The call for universal social insurance is thus much more than simply a recognition that the status quo fails along key dimensions and the statement of a social desideratum. It is also a guidepost that indicates that whatever reforms countries can undertake in the future – small or large, fast or slow – should have as a guiding post the objective of universal coverage. Translating this guidepost into concrete policies depends very much on the political context and peculiarities of each country. But, that said, the guidepost will avoid continuing with the sequence of isolated and contradictory reforms that has been observed in the past, and which have brought us to the unfortunate situation in which social protection is found in LA today.



© Charlotte Kesl

¹ Beveridge Report 1942

WIDER ANNUAL LECTURES

- 22 | The Political Economy Of Structural Transformation: Has Democracy Failed African Economies?
Ernest Aryeetey
- 21 | How are People Poor?
Sabina Alkire
- 20 | Interventions against Poverty in Poor Places
Martin Ravallion
- 19 | Development research and changing priorities
Amartya Sen
- 18 | Managing Structural Transformation: A Political Economy Approach
C. Peter Timmer
- 17 | Egalitarian Principles: The Foundation for Sustainable Peace
Martti Ahtisaari
- 16 | The Folk and the Formula: Fact and Fiction in Development
Lant Pritchett
- 15 | From Flying Geese to Leading Dragons: New Opportunities and Strategies
for Structural Transformation in Developing Countries
Justin Yifu Lin
- 14 | Reforming the International Monetary System
José Antonio Ocampo
- 13 | The Trade-Development Nexus in Theory and History
Ronald Findlay
- 12 | Developing Countries in the World Economy: The Future in the Past?
Deepak Nayyar
- 11 | The Climate Change Challenge
Kemal Derviş
- 10 | Global Patterns of Income and Health: Facts, Interpretations, and Policies
Angus Deaton
- 9 | The World is Not Flat: Inequality and Injustice in our Global Economy
Nancy Birdsall
- 8 | Rethinking Growth Strategies
Dani Rodrik
- 7 | Global Labour Standards and Local Freedoms
Kaushik Basu
- 6 | Winners and Losers in Two Centuries of Globalization
Jeffrey G. Williamson
- 5 | Horizontal Inequality: A Neglected Dimension of Development
Frances Stewart
- 4 | Globalization and Appropriate Governance
Jagdish N. Bhagwati
- 3 | Is Rising Income Inequality Inevitable? A Critique of the Transatlantic Consensus
Sir Anthony B. Atkinson
- 2 | More Instruments and Broader Goals: Moving Toward the Post-Washington Consensus
Joseph E. Stiglitz
- 1 | The Contribution of the New Institutional Economics to an Understanding of the Transition Problem
Douglass C. North

The collection of Annual Lectures 1997–2004 is available as:
Wider Perspectives on Global Development
Published in Studies in Development Economics and Policy, by Palgrave Macmillan (ISBN 9781403996312)



www.wider.unu.edu