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Social Protection in a Changing World

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The Challenge of Socially Inclusive Growth: Lessons from Latin America

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Introduction

- Socially inclusive growth requires social protection systems to mitigate increasing income inequalities that are often associated with economic growth.

- As incomes increase, middle and low-income households demand more and better health care.

- Increases in life-expectancy and demographic transitions often translate into pressures to protect the elderly against old-age poverty.

- Urbanization increases the political salience of these demands.

- However, designing effective social protection systems is a challenge. Governments need to balance considerations of budgetary costs, redistribution, and efficiency.

- The experience of countries in Latin America, positive and negative, can be useful to countries in other regions, particularly to those where informal employment is large.

Social protection systems in Latin American (1/4)

- Cornerstone is the "Bismarckian model":
  - pensions, health and other programs for salaried (or dependent) workers paid from an earmarked wage-based tax,
  - protections for loss of employment via stringent firing conditions; secondary role for unemployment insurance, if any,
  - sometimes high minimum wages (relative to wage distribution).
- Coverage restricted to < 50% of the labor force (with variations across countries).
- Pressures to expand coverage to those left out increased in 1990s, as growth resumed and democracy expanded.
- Strong desire to increase coverage and spending in social protection, **BUT** an unwillingness to reform the Bismarckian model.
- Expansion took place in ad-hoc manner, through a series of "scheme-by-scheme" additions of programs. A mix of:
  - targeted income transfers for the poor (like Progresa in Mexico or Bolsa Familia in Brazil),
  - "non-contributory" health and pensions programs for informal workers (i.e., financed from general revenues).

Social protection systems in Latin America (2/4)

Insurance

Redistribution		Formal	Informal + unemployed + OLF
	Non-Poor	A	C
	Poor	B	D

A + B + C + D = working age population

B + D:
- ✓ transfers in cash, often with behavioral conditions (CCTs)

A + B:
- ✓ bundled health, pension and other financed from <u>wage-based tax</u>
- ✓ strict firing regulations
- ✓ minimum wages

C + D:
- ✓ unbundled health and pensions financed from <u>general revenues</u>
- ✓ no firing regulations
- ✓ no minimum wages

Firms and workers pay for benefits in A + B, but not in C + D.

Firms face minimum wages and dismissal regulations in A + B, but not in C + D.

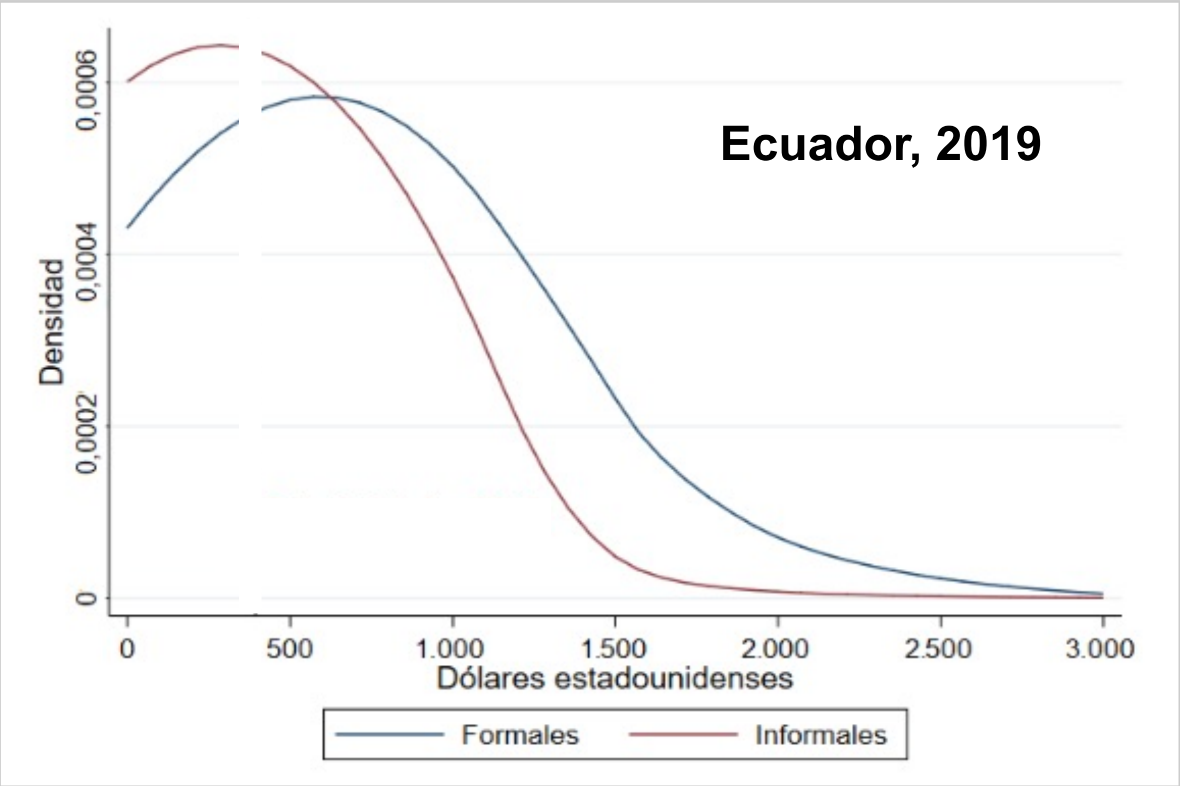
Social protection systems in Latin America (3/4)

1. Formal-informal transitions

Dominican Republic, 2018-19

	F	I	U	OLF
F	78.9	9.7	3.3	8.1
I	12.5	74.0	1.9	11.6
U	17.4	30.4	29.0	23.2
OLF	5.7	14.7	1.8	77.8

3. Wage distributions



2. Long term permanence in formality

Contribution densities

	Period	Average	Dispersion
Colombia	2010-2020	42%	1 MW = 39%. ; between 5 and 10 MW = 68%
Mexico	1997-2015	46%	1 MW = 13%. ; 3 MW = 52%; 10 MW = 74%

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Social protection systems in Latin America (4/4)

- Informality and poverty sometimes confused. This is a mistake: most poor workers are informal but most informal workers are not poor (in the previous matrix, almost everywhere C > D).

- There are large differences in spending:

  - ✓ **targeted poverty programs usually absorb about 0.5% of GDP.**

  - ✓ **non-contributory health and pensions programs absorb between 2 to 5% of GDP.**

- Individual workers transit between formal and informal employment, particularly in urban areas.

- Average time in formality ≈ 50% of time people are employed, but formality spells correlated with incomes.

Problem 1: Efficacy

Insurance

- Incomplete and erratic protection against risks, particularly for lower-income workers.
- Contributory pensions only work for a minority of mostly high wage workers.

Poverty

- CCT-like transfers improve indicators of human capital but translate poorly into higher productivity jobs.
- CCTs can create ‘informality traps’ or lower participation rates.
- “Graduation” from CCTs is obstructed because of high informality in the labor market.

Inequality

- Contradictory impacts of Bismarckian regime on inequality:
  - ✓ most firms very small: income of owners ≈ income of workers; redistribution from firm to worker ≠ from rich to poor
  - ✓ exclusion of low-income workers from pensions, often losing part or all of contributions; higher-income often subsidized
  - ✓ informal workers excluded but bear costs through lower wages, as formal employment is restricted and the supply of labor to the informal sector increases.

- Redistribution mostly through non-contributory programs and targeted transfers.

Problem 2: Efficiency

Formality:

✓undervalued contributory programs and sometimes high minimum wages (relative to countries' earnings distributions), tax formality or create barriers to enter it.

Informality:

✓subsidized by non-contributory programs (free social benefits conditional on being informal).

Smallness:

✓partly a result of incentives for self-employment or micro-firms legally excluded from the Bismarckian regime, both subsidized by non-contributory programs (and sometimes by micro-credits and the like).
✓partly a result of enforcement of the Bismarckian regime inversely proportional to firm size.
✓partly a result of special tax and contribution regimes for small firms.

The result is an incentive system that misallocates resources and hurts productivity and growth.

Bottom line

- **Despite large increases in spending in social protection** (≈ from 7% of GDP in 1990 to 14% in 2020):
  - ✓ LA continues to be one of the most unequal regions in the world,
  - ✓ Little change between Gini of market income and Gini of income after taxes and transfers:
    OECD: from 0.47 to 0.30, or **0.17 points** versus **LA**: from 0.51 to 0.49, or **0.02 points**.
  - ✓ Human capital indicators have improved and poverty has fallen but is high relative to the regions' per capita income,
  - ✓ LA has experienced almost no TFP growth since the early 1990s, in part because of persistent informality.

- Many other factors also explain these outcomes, but clearly social protection systems play a critical role.

- (PS: For reasons of time, no discussion of problem 3: fiscal sustainability.)

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Conclusions

- In 1990s LA pioneered income transfers to the poor via Conditional Cash Transfer programs. On balance, this was a positive innovation, as shown by many evaluations that show reductions in income poverty and improvements in human capital indicators.

- However, at the same time, the region developed a ‘second-tier’ parallel system of social insurance for informal workers through a variety of pension, health, day-care and related programs, with varying quality, scope and coverage.

- Programs developed in an uncoordinated manner, on a “scheme-by-scheme” basis, without due consideration to their impact on firm and worker behavior in the labor market.

- One key problem is a dual social insurance architecture constructed around workers’ status in the labor market.

  - ✓ this architecture generates an unwanted trade-off between improving social benefits for informal workers (desired) vs. increasing distortions that depress productivity (not desired).

  - ✓ further, it does not adjust well to the dynamics of a labor market driven by innovation, technical change, and so on; the notion of “dependent workers” is too rigid and backward looking.

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- Another key problem is the conflation of insurance with income transfers, all under the umbrella concept of “social protection”.

- And yet a third problem is that discussions of social protection programs rarely consider their impact on the behavior of firms and resource allocation. (We ignore here issues of fiscal sustainability.)

- Countries in other regions of the world wanting to expand coverage of social protection need to be aware of these problems and design their social protection systems to avoid or minimize them.

- A key suggestion is to develop a long-term vision of the desired social protection system to guide policy, even if this vision is implemented gradually. It is essential to <u>avoid improvisation and ad-hoc reactions to political pressures</u> or short-run shocks.

- **One final observation.** There is, of course, large heterogeneity across countries. But in the presence of large informality and economic structures like Latin America’s, socially inclusive growth is not the result of “policies for growth” on one hand, and “policies for social protection”, on the other; a more holistic view is required.

Thank you.