Long regarded as a region beset by macroeconomic instability, high inflation, and excessive poverty and inequality, Latin America has undergone a major transformation over the last 20 years. After the “lost decade” of the 1980s, many countries underwent successful macroeconomic stabilization programs, accompanied in some cases by large trade reforms and fundamental institutional innovations like granting autonomy to their central banks. During the 1990s and extending into the 2000s, the region’s GDP grew at an average annual rate of 3.3 percent (on a population-weighted basis), more than double the 1.5 percent rate observed in the 1980s. Inflation, long the region’s scourge, has by-and-large been contained in most countries—in 2011, inflation was 10 percent in Argentina (although there is some controversy about this figure), 7 percent in Brazil, and below 4 percent in Chile, Colombia, Mexico, and Peru. This marks a sharp improvement from the 1990s, which included hyperinflationary episodes in Argentina, Brazil, and Peru. With much better monetary policy, substantially lower fiscal deficits, and improved debt management, most countries in the region were resilient to the 2008–2009 world financial crisis. For Latin America as a whole, unemployment rates rose by less than 1 percentage point, and poverty rates continued to decline, albeit at a lower rate than in previous years. Indeed, for the first time in living memory, many governments were able to conduct effective countercyclical macroeconomic
In 2011, the stock of international reserves for the region stood at $752 billion, including $351 billion in Brazil, $149 billion in Mexico, and more than $40 billion each in Argentina, Chile, and Peru. By comparison, total international reserves for the region were $151 billion a decade ago.

The region’s achievements go beyond improved macroeconomic management. The last decade has witnessed substantial and sustained reductions in poverty and inequality, as shown in Figure 1. Poverty fell in virtually every country, and for the region as a whole, the fraction of people living on less than $2.50 per capita per day fell from 26.8 to 13.3 percent, implying that 55 million fewer people lived under the poverty line in Latin America in 2011 than in 2000. The declines in inequality are impressive, too. In 2000, the Gini coefficient was above 0.5 in Argentina, Brazil, Chile, Colombia, Mexico, and Peru, and above 0.45 in Venezuela. By 2011, it had fallen by 6 percentage points or more in Argentina, Brazil, Peru, and Venezuela; by more than 3 percentage points in Chile and Mexico; and by 2 points in Colombia.

In previous crises, many countries in Latin America had weak fiscal positions, high inflation, or scarce access to international financial markets, constraining their ability to use fiscal and monetary policy to boost growth in the face of negative output shocks.

Source: Authors’ calculations based on data from the SEDLAC database (Socio-Economic Database for Latin America and the Caribbean) maintained by CEDLAS (Center for Distributional, Labor and Social Studies at the Universidad Nacional de la Plata) and the World Bank, as well as data from the Economic Commission for Latin America and the Caribbean, the Inter-American Development Bank and the World Bank.
There have also been steady improvements in various nonmonetary measures of well-being. Between 1990 and 2010, infant mortality in Latin America fell from about 120 to 60 deaths per 1,000 live births, maternal mortality fell from 50 to 25 per 100,000 live births, and chronic malnutrition (or stunting) among children age 5 and younger fell from 25 percent to 12 percent of the population. As we discuss below, there have been continued increases in both school enrollment rates and in the mean years of schooling attained. Finally, and of great importance, the health and education outcomes of girls in the region are now on par with, or surpass, those of boys.

Interregional comparisons help to put these achievements in perspective, however. Growth rates in Latin America continue to be much lower than in East Asia—in the 2000s, GDP grew by 10.4 percent per year in China, 7.1 percent in Vietnam, and 4.1 percent in Korea. At current average growth rates, it will take Brazil 21 years to reach the current GDP per capita of Korea, and Mexico will need 25 years. Moreover, one can also argue that at least part of the good growth performance observed in the last decade is the result of an old-fashioned commodity boom associated with growth in Asia and, at least through 2008, unusually favorable circumstances in international capital markets. Figure 2 compares total factor productivity growth in East Asia, Latin America, and the United States from 1980 to 2007: in East Asia, productivity growth has been faster than in the United States, while in Latin America it was negative up to 2000 (IDB 2010). Since then,
productivity growth has been similar in Latin America and the United States, but the region has continued to lose ground relative to East Asia.

In parallel, savings and investments rates in the region continue to be very low relative to those observed in Asia. Savings rates in Latin America range from 18 percent of GDP (in Brazil) to 24 percent (in Mexico and Chile), which contrasts with 31 percent in India, 34 percent in Malaysia, and 51 percent in China. And, despite recent gains, Latin America continues to be the most unequal region of the world and, because of this, is characterized by poverty rates that are much higher than one would expect given the region’s income level.2

For growth to be both faster and more equitable, Latin America needs to focus sharply on accelerating productivity growth; on raising its savings rate to sustain a larger investment effort (particularly in infrastructure); on increasing the human capital of its workforce; and on new policies to reduce inequality.

In this paper, we focus on a subset of these issues. In particular, we argue that social policy, including human capital and education, social insurance, and redistribution, need special attention if Latin America’s achievements over the last two decades are to be sustained and amplified. Starting in the mid 1990s, many governments in the region introduced a variety of programs, including noncontributory pensions and health insurance, and cash transfers targeted to the poor. Social spending in Latin America increased sharply. A growing political and technocratic consensus developed around the need for policies to ensure that the poor have a minimum income floor, are protected from various risks, and have the human capital that will allow them (or their children) to escape poverty. These policies have been widely praised and, like others, we believe they have resulted in substantial improvements in the lives of the poor in the region. However, a more nuanced view shows some worrisome trends. Moving forward, we believe it is necessary to pay much closer attention to the quality of services, particularly in education; to the incentives generated by the interplay of some programs, particularly in the labor market; to a more balanced intertemporal distribution of benefits, particularly between young and old; and to sustainable sources of finance, particularly to the link between contributions and benefits.

An important caveat is in order before we begin: Latin America is a heterogeneous region. Countries differ in size, income levels, institutions, and endowments. What follows are broad strokes that may not always apply to all countries, and any implications for policy would have to be scrutinized and adapted to specific circumstances.

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2 Simple simulations illustrate this point. Uruguay is the least unequal country in Latin America, with a Gini coefficient of 0.40. We simulate poverty levels in Mexico, Brazil, and Chile if their mean income levels were unchanged but the distribution of income was that of Uruguay. These simulations suggest that, in Mexico, which has a Gini coefficient of 0.48, the number of poor people would fall by half; in Brazil, which has a Gini of 0.53, by more than two-thirds; and in Chile, which has a Gini coefficient of 0.52, by more than four-fifths. Of course, there is no realistic set of policies that could redistribute income while keeping mean income at the same level. But the simulations illustrate that the region’s unequal distribution of income mechanically results in high levels of poverty.
Latin America has an impressive record of expanding the coverage of basic education. Net enrollment rates, given by the fraction of children who are enrolled at the appropriate level for their age, now exceed 90 percent in primary school and are between 60 and 80 percent in secondary school in most countries. Broadly speaking, countries in the region have enrollment rates that are similar to those of other countries with similar income levels (Inter-American Development Bank 2011). On average, individuals born in 1945 in Latin America completed six grades of schooling, while those born in 1985 have completed ten grades.

Unfortunately, increases in schooling levels have not been accompanied by increases in quality. The performance of Latin American students on standardized tests is dismal. Argentina, Brazil, Chile, Colombia, Mexico, Panama, Peru, and Uruguay participated in the International Programme for International Student Assessment (PISA), which tested competencies in language, mathematics, and science for 15 year-olds. Their scores are relatively similar to each other, with Chile and Uruguay performing somewhat better and Panama and Peru somewhat worse. However, students in Panama score below those in Indonesia, even though GDP per capita in Indonesia is about one-third that in Panama, and those in Argentina have scores that are approximately 100 points (one standard deviation) below those in Poland. Only 5 percent of Chilean students score at or above the median score of students in Singapore, and only 1.5 percent score at or above the median of students in Shanghai, as shown in Figure 3; the same is true of Uruguay. Even children in the best schools in the region appear to perform poorly. We calculated the PISA math

![Math Scores among 15-Year Olds, Latin America and East Asia (2009)](chart)

Source: Authors’ calculations based on data from OECD Program for International Student Assessment (PISA), 2009.

**Schooling**

Latin America has an impressive record of expanding the coverage of basic education. Net enrollment rates, given by the fraction of children who are enrolled at the appropriate level for their age, now exceed 90 percent in primary school and are between 60 and 80 percent in secondary school in most countries. Broadly speaking, countries in the region have enrollment rates that are similar to those of other countries with similar income levels (Inter-American Development Bank 2011). On average, individuals born in 1945 in Latin America completed six grades of schooling, while those born in 1985 have completed ten grades.

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scores limiting the sample to the 10 percent best-performing schools that participated in this test in Chile and Uruguay, and found that only 10 percent of children in these high-performing schools in Chile, and 13 percent in Uruguay, have scores as high as the average child in Shanghai. Moreover, such comparisons likely understate the differences across countries, because the PISA only tests 15-year-old children currently enrolled in 7th grade or above, and grade repetition and dropout rates are higher in Latin America than in East Asia.

There is a broad consensus among policymakers and researchers that the very low performance of Latin American students on standardized tests has negative implications for productivity. A simple accounting exercise by Hanushek and Woessman (2012) suggests that at least half of the Latin American low-growth “puzzle” can be attributed to low levels of cognitive skills among students, as measured by test scores. Further, because poor children in Latin America generally attend lower-quality schools than their better-off counterparts, it also has negative implications for equity.

Why do Latin American students perform so poorly on international tests? Two reasons are particularly important: factors that affect children before they enter school, and the poor quality of teachers. In the region, many children arrive at the beginning of formal schooling with serious deficits in health and development. Rates of chronic malnutrition (low height-for-age, or stunting) are very high in some countries, especially among the poor. In Guatemala, more than half the children under the age of five are more than two standard deviations behind in height, relative to a reference population of well-nourished children. In Bolivia, Ecuador, and Peru, the number is between 20 and 30 percent, but among the poorest households, especially those in rural areas, the fraction is more than double. Poor nutritional status in early childhood has serious implications for cognitive functioning, and the damage may be largely irreversible.

Other indicators also suggest that poor Latin American children begin schooling already behind. Schady et al. (2012) show that, by the time they enter school, the poorest children in rural Chile are about two-thirds of a standard deviation behind where they should be on their performance on a test (the Spanish-speaking version of the Peabody Picture Vocabulary Test) that has been shown to be highly predictive of school failure; in Colombia and Ecuador these delays are about one-and-a-half standard deviations; and in Nicaragua and Peru, the poorest children in rural areas are more than two standard deviations behind, which implies delays of about two years in their cognitive development.

Although the evidence from Latin America is sparse, there seems to be considerable scope for interventions targeted at young children—especially those in poor households, who exhibit the biggest delays (see Schady 2012 and Vegas and Santibañez 2010 for reviews). In Argentina, children in cohorts and regions that were exposed to a preschool program have test scores in third grade that are 0.23 standard deviations higher than those who were not exposed, have fewer behavior problems and are more likely to pay attention in class and participate (Berlinski, Galiani, and Gertler 2009). In Uruguay, plausibly exogenous variation
in access to preschool is associated with 0.8 more years of completed schooling by the time children are 15 years of age (Berlinski, Galiani, and Manacorda 2008). In Colombia, a pilot home-visiting and parenting program improved cognitive development among young children by about 0.3 standard deviations (Attanasio, Fitzsimons, Grantham-McGregor, Meghir, and Rubio-Codina 2012). In Guatemala, a program that distributed a high-protein energy drink known as Atole to poor children in early childhood improved chronic malnutrition, schooling, test scores, and men’s wages almost 20 years later (Behrman, Calderon, Preston, Hoddinott, Martorell, and Stein 2009; Hoddinott, Maluccio, Behrman, Flores, and Martorell 2008; Maluccio, Hoddinott, Behrman, Martorell, Quisumbing, and Stein 2009).

Teachers in many Latin American countries have deficiencies in content knowledge and basic teaching practices. Peru applied tests of content knowledge to all teachers in 2007. Almost 50 percent of math teachers could not perform basic arithmetic operations and about one-third lacked basic reading comprehension skills. Using data for Peru, Metzler and Woessman (2012) estimate that higher levels of teacher content knowledge in language and (especially) math translate into better learning outcomes for children. In Chile, in any given year, roughly one-third of teachers are deemed to have unsatisfactory performance on the performance evaluation system known as Docente Más. In Ecuador, the Classroom Assessment Scoring System (CLASS), a measure of the quality of teaching practices which focuses on socioemotional support, classroom management, and instructional support provided by teachers (Mashburn, Downer, Hamre, Justice, and Pianta 2010; Pianta 2011; Pianta and Hamre 2009) was applied to a sample of teachers between first and third grade. Roughly 90 percent received the lowest possible score of 1, on a scale of 1 to 7, in terms of the instructional support they provide (Araujo, Cruz-Aguayo, and Schady 2012). In Chile, teacher scores are somewhat better than in Ecuador, but only marginally so (Yoshikawaw et al. 2012).

In sum, advances in schooling coverage in Latin America are welcome, but are clearly not enough. The interplay of deficiencies generated at an early age with poor-quality teachers and at times inadequate facilities and content implies that children in Latin America, particularly poor ones, are not learning enough and enter the labor market with substantial disadvantages relative to their peers in other

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5 The Colombian program was designed on the basis of a similar program in Jamaica. An efficacy trial of the Jamaica intervention showed that children randomly assigned to receive visits by health paraprofessionals who worked with mothers on early stimulation had cognitive scores that were approximately 0.4 standard deviations higher than children randomly assigned to the control group. Almost two decades after the intervention ended, participants had better performance on tests of math and reading, higher levels of completed schooling (about one-third more years), lower levels of depression and involvement in violent criminal activity, and better labor market outcomes (Grantham-McGregor, Walker, Chang, and Powell 1997; Walker, Grantham-McGregor, Powell, and Chang 2000; Walker, Chang, Powell, and Grantham-McGregor 2005; and Walker, Chang, Vera-Hernández, and Grantham-McGregor 2011). More recent results following up the children in this sample suggest the intervention also raised employment and earnings in early adulthood (Chang et al. 2012).
parts of the world. This is clearly a weak platform from which to improve productivity and reduce the intergenerational transmission of inequality.\textsuperscript{4}

**Social Insurance**

Social insurance aims to protect households against risks—ill health, unemployment, disability, death, or poverty in old age (the latter associated with uncertainty about longevity)—and to contribute to intertemporal consumption smoothing. The central feature of social insurance in most of Latin America is that both the provision and the financing are a function of labor status: in particular, whether a worker is salaried (having a boss and receiving payment in the form of wages) or nonsalaried (self-employed, working on a piece-rate basis, or working in a family firm). As a result, social insurance is intertwined with the functioning of the labor market, with broad implications for the efficacy of these programs, as well as for domestic savings and for productivity (Levy 2008; Ferreira and Robalino 2011).

In most counties in Latin America, salaried workers are entitled to a bundle of benefits including, among others, health, work-risk, death and disability insurance, and retirement pensions, and sometimes other benefits like child allowances (Argentina), labor training services (Colombia), or housing and daycare services (Mexico). These benefits are paid from wage taxes. The bundle and the method of financing are usually referred to as “contributory social insurance.” In addition, salaried workers are protected against loss of employment through legal requirements for severance pay and related indemnities.\textsuperscript{5} In what follows, contributory social insurance should be understood as encompassing employment protection regulations, and health, pensions, and other benefits, as firms and workers must internalize the costs of all these items.

In practice, because regulations are imperfectly enforced, firms sometimes evade and hire salaried workers illegally; and because not all workers participate

\textsuperscript{4} “Inequality of opportunity” can be defined as the proportion of total inequality that is explained by predetermined characteristics unrelated to individual effort, like parental education, race, gender, or place of residence. Brunori, Ferreira, and Peragine (2013) argue that inequality of opportunity is higher in Latin America than in other regions. Latin America also has particularly low levels of educational intergenerational mobility—the education of parents is a stronger predictor of the education of children in Latin America than elsewhere (Hertz, Jayasundera, Piraino, Selcuk, Smith, and Verashchagina 2007).

\textsuperscript{5} In Latin America, protection against loss of employment typically takes the form of a one-time payment at the time of dismissal, rather than a flow of pre-payments into an insurance fund. Severance pay should in principle be fully internalized by workers in the form of lower wages, with no inefficiency involved. But in practice this is not so, because in Latin America a distinction is made between “just” and “unjust” dismissals (with output adjustment by a firm not considered a just cause for dismissal). This makes severance pay subject to uncertainty, high transaction costs, and delays (an important consideration in the presence of liquidity constraints). In Mexico, for example, trials for severance pay take an average of three years, and it is estimated that lawyers keep about 30 percent of payments (Kaplan, Sadka, and Silva-Mendez 2008; Kaplan and Sadka 2011).
in the market as salaried employees, contributory social insurance only covers a subset of the labor force, in what is commonly referred to as “formal employment.” Figure 4 shows that the share of the labor force covered by contributory social insurance is below 50 percent in most countries in the region, despite the fact that these programs have been obligatory for over half a century.

Until relatively recently, nonsalaried and illegally hired salaried workers—in what is commonly referred to as “informal employment”—were not covered by social insurance in Latin America. Many countries had some publicly provided health care for all, regardless of salaried status, but it was largely limited to basic interventions for maternal and child health. However, over the last two decades, governments across Latin America have created or expanded health, pension, and related programs that are paid from general revenues and thus are referred to as “noncontributory social insurance.”

These noncontributory social insurance programs have grown rapidly in terms of budget and coverage. Table 1 lists 13 countries in the region with programs of noncontributory pensions, at an average cost of 0.56 percent of GDP. A number of countries have also introduced noncontributory health programs. The two largest are in Colombia and Mexico, although similar schemes are
found in Peru and Nicaragua and, with some variations, in Argentina, Bolivia, and Ecuador. Colombia introduced its Régimen Subsidiado en Salud in the early 1990s, initially providing benefits of lower quality to informal workers relative to those offered to formal workers through the Régimen Contributivo. Mexico had offered free health services to informal workers through various programs since the 1980s, but in 2003 launched a major effort to expand coverage through the Seguro Popular.

These noncontributory programs have substantially expanded the coverage of pensions and health insurance. In Brazil’s Previdência Rural pension program, coverage among those eligible increased by 40 percentage points within a decade, from a pre-reform level of about 13 percent (Bosch, Cobacho, and Pages forthcoming; Carvalho Filho 2008). Argentina’s Moratorium increased pension coverage by 27 and 16 percentage points for women and men from a pre-reform level of 30 and 55 percent, respectively (Bosch and Guajarro 2012). Mexico’s Seguro Popular expanded rapidly: by 2010, it covered more than 43 million affiliates, according to the program’s administrative data. And Colombia’s Régimen Subsidiado increased the

Table 1
Noncontributory Pensions and Conditional Cash Transfer Programs in Latin America, 2011

<table>
<thead>
<tr>
<th>Country</th>
<th>NCP</th>
<th>Age (thousand)</th>
<th>People</th>
<th>% of elderly</th>
<th>$US (monthly)</th>
<th>% GDP</th>
<th>Coverage</th>
<th>Transfers</th>
<th>Coverage</th>
<th>Transfers</th>
<th>Coverage</th>
<th>Transfers</th>
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<td>178</td>
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<td>29,143</td>
<td>22.6</td>
<td>64</td>
<td>0.37</td>
<td></td>
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</tbody>
</table>

Source: Authors’ calculation based on data from official records.

* Includes two noncontributory pensions: Benefício de Prestação Continuada and Previdência Rural.

** Includes only the 70 y Más program, and not the 18 state and municipal pension noncontributory pension programs.

*** Averages based on the demographic structure of household in the poorest quintile.
coverage of health insurance from levels below 30 percent to more than 90 percent today (Camacho, Conover, and Hoyos 2012).

By extending coverage, noncontributory social insurance programs provide some protection against risks to households who would otherwise be unprotected. In Mexico, the Seguro Popular decreased participants’ catastrophic health expenditures by 23 percent (King et al. 2009), and the 70 y Más program, which provides pensions for those 70 years or older, reduced the poverty gap among recipients from 0.61 to 0.46 (Galiani and Gertler 2009). Papers that have modeled the likely effect of the 2008 pension reform in Chile, which introduced a noncontributory pension for the poorest 60 percent of the population, also conclude that it will substantially reduce poverty (Attanasio, Meghir, and Otero 2011; Todd and Joubert 2011). In other cases, the declines in income poverty are smaller because noncontributory pensions allow a larger share of the elderly to stop working (for evidence from Brazil, see Carvalho Filho 2008; for evidence from Mexico, see Galiani and Gertler 2009; Juárez and Pfutze 2012).

Without minimizing these accomplishments, noncontributory social insurance programs do raise various concerns. First, noncontributory programs can be expensive. For example, in the Brazilian Previdência Rural program, the value of the pension is large (equivalent to roughly one-third of per capita GDP), and the eligibility age low (60 years for men, 55 for women). As a result, the cost is high, about 0.89 percent of GDP, even though only workers in rural areas are eligible for the program. The Argentinean Moratorium cost between 1.5 and 2 percentage points of GDP in the year it was implemented. Moreover, because Latin America’s population is aging rapidly, the costs of noncontributory programs could increase substantially in the coming decades. The fraction of the population 65 and over in the Latin America is projected to increase from 7.6 percent of total population in 2010, to 21 percent in 2050; by 2050 there are projected to be three working-age individuals for every person age 65 and older, compared to 8.5 in 2010 (ECLAC 2011). These programs can therefore impose large future liabilities. A related political economy concern is that noncontributory programs face ongoing pressure for increases in coverage and benefits, because unlike contributory programs, benefits and contributions are not directly linked. For example, in 2007 Mexico’s 70 y Más program only covered elderly above age 70 living in towns with less than 2,500 inhabitants; in 2008, it was expanded to include towns with less than 20,000; in 2009, to towns with less than 30,000; in 2012, an election year, eligibility was extended to all, regardless of place of residence; and in 2013, the eligibility age was reduced to 65. A similar situation occurred in Colombia, where the health package financed by the Régimen Subsidiado (for informal workers) was initially less generous than that offered by the Régimen Contributivo (for formal workers). In 2008, however, the Constitutional Court required that the package of health benefits in the two programs be equated.

The provision of noncontributory social insurance programs can also discourage formal employment, because informal workers receive benefits without paying for them in the form of a wage tax. In 2009, Argentina extended to informal workers the subsidy for minors less than 18 years of age, previously paid only to formal
workers, through a program known as the Asignación Universal por Hijo[^6]. By 2011, the program covered 29 percent of all eligible minors at a cost of 0.64 percent of GDP. Garganta and Gasparini (2012) estimate that this program reduced the probability that informal workers would enter into formal employment by 45 percent for women and 30 percent for men. Bosch and Campos (2010) analyze the impact of Mexico’s Seguro Popular, comparing the growth rates of firms registered with the Mexican Social Security Institute in municipalities where Seguro Popular was implemented early, in 2002–2003, with those where it was implemented later, in 2006–07. They show that, four years after it started, Seguro Popular had translated into a 5 percent reduction in formal employment in municipalities that received the program earlier. On the basis of this and similar calculations, Bosch, Cobacho, and Pages (forthcoming) estimate that between 2002 and 2010 Seguro Popular resulted in a relocation of between 0.4 and 1 percentage points of total employment from formal to informal jobs, which is equivalent to between 160,000 and 400,000 workers, or between 8 and 20 percent of the total formal jobs created during that period. The analysis by Camacho et al. (2012) of Colombia’s Regimen Subsidiado suggests qualitatively similar, but substantially larger effects on informality, about 4 percentage points.

More broadly, the segmentation of social insurance into contributory and noncontributory components has three important implications: 1) it reduces the overall efficacy of insurance; 2) it may reduce domestic savings; and 3) it misallocates resources, which can have negative impacts on productivity and growth. We will say a few words about each effect.

The efficacy of insurance is reduced because, across Latin America, transitions from formal to informal employment and back are frequent. In any given year in Argentina and Brazil, 25 and 47 percent of informal workers transit into a formal job, respectively, while 9 and 7 percent transit in the other direction (Ribe, Robalino, and Walker 2012). Because workers only accumulate pension benefits when they are formally employed, contribution densities to pension plans are low. Even in Argentina, Chile, and Uruguay, three of the countries with the highest coverage of contributory social insurance in the region (as shown earlier in Figure 4), mean contribution densities are low at 55 percent, 47 percent, and 58 percent, respectively (Forteza, Luchetti, and Pallares 2009). As a result, the replacement rate, the amount of before-retirement income replaced by the pension, will be low, and contributory pensions will do a poor job helping individuals to smooth consumption between work and retirement. Also, transits between formal and informal employment result

[^6]: Argentina’s Asignación Universal por Hijo can also be thought of as a conditional cash transfer program of the sort discussed in the next section. The program was means-tested, was limited to households with children, and benefits were conditioned on school enrollment and use of preventive health services by young children. However, unlike other conditional cash transfer programs, the Asignación Universal por Hijo extended to informal workers a benefit that formal workers already received, with the key difference that the benefit for formal workers was paid for by a wage tax while that for informal workers was paid for out of general revenues.
in erratic coverage against risks that are only covered by contributory social insurance (like death, disability, and loss of employment).

In terms of effects on saving, many countries in Latin America reformed their pension systems in the 1990s, often replacing defined benefit with defined contribution programs (Uthoff 2011). One goal of these reforms was to increase the supply of long-term domestic savings denominated in local currency. Although mandating increased pension savings can in principle be offset by reduced private saving, the balance of the available evidence from Latin America shows that this offset has not occurred on a one-to-one basis, implying that forced savings through contributory pensions have increased domestic savings (Aguila 2011; Carpio 2008; Cerda 2008; Quintanilla 2011). However, because the coverage of contributory pensions is so limited, the contribution of these programs to national saving is also limited. The extension of noncontributory pension programs is likely to further undermine individual incentives to save through the contributory system.

Finally, the segmentation of social insurance may be a factor behind the stagnation of productivity growth in the region. On the one hand, if benefits from contributory social insurance are not fully valued by workers, contributory programs act like a tax on formal employment. On the other hand, noncontributory social insurance programs function as a subsidy to informal employment because informal workers receive at least some of the same benefits as formal workers, with the critical difference that they do not pay for them from foregone wages. Moreover, when contributory social insurance and regulations are imperfectly enforced, firms may hire salaried workers illegally but remain inefficiently small to minimize the chance of detection. Taken together, these taxes and subsidies distort the price of labor towards more small firms with salaried labor, more family firms with nonsalaried labor, and more informal employment. In Mexico, Busso, Fazio, and Levy (2012) find that 90 percent of the 3.6 million firms captured in the Census have up to five workers, 96 percent up to ten, and only 1 percent more than 50; but less than three in four firms are registered with the Social Security Institute (a prerequisite for formality). An emerging literature shows that productivity in the informal sector is lower than in the formal one, so any resource movements from the former to the latter will tend to lower aggregate productivity (Fajnzylber, Maloney, and Montes-Rojas 2009, 2011; Busso, Fazio, and Levy 2012; Jung and Tran 2012; Pagés 2010).

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8 Moreover, this count probably overstates the share of larger firms, because the Census only accounts for about 50 percent of private employment. The rest of private employment is either self-employment, or occurs in small firms not captured by the Census, like street stands or street markets. Firms in Latin America may choose to be inefficiently small (from a social point of view) for a variety of reasons, in addition to the incentive to avoid social insurance regulations. For example, many countries have special tax regimes whereby smaller firms face substantially lower rates of value-added or income taxes (Pagés 2010).
Inequality and Social Assistance

Countries in Latin America have experienced highly unequal distributions of income since at least the middle of the nineteenth century, if not before.[9] Inequality in the region appears to have been particularly high in the 1980s—a result of numerous macroeconomic crises and the adjustment processes that followed (Gasparini and Lustig 2011; Gasparini, Cruces, and Tornarolli 2011; López-Calva and Lustig 2010). But the last decade has seen substantial reductions in inequality. Moreover, inequality fell in countries with different political orientations, with relatively large and small governments, with large and small shares of social spending, and with historically high and low levels of inequality. For this reason, the search for causes of the inequality decline in Latin America has focused on broad trends cutting across the region.

Decompositions suggest there are two main explanations for the decline in inequality in the region in the last decade: A reduction in the wage premium for skilled labor, and increases in the coverage of social programs. The rate of return to schooling in the region increased in the 1980s and 1990s, but fell in the 2000s. As a result, the share of labor income at the bottom of the distribution increased, which accounts for between one-third and one-half of the inequality decline. Meanwhile, the expansion in pension coverage (mainly noncontributory pensions, although data limitations often make it difficult to separate contributory and noncontributory pensions in household surveys) accounts for maybe 5 percent of the decline, and programs that make cash transfers to the poor account for roughly one-quarter of the decline.[10]

[9] The question of just when Latin America began to exhibit high inequality of incomes is under dispute. Robinson and Sokoloff (2004) and Sokoloff and Engerman (2000) argue that Latin America has been unequal for centuries, a result of the European conquest, the abundant natural resources (in particular minerals), and the comparative advantage of the region in the production of crops such as sugar. Williamson (2009) argues that “historical persistence in Latin American inequality is a myth” and that the region only became unusually unequal in the second half of the nineteenth century.

[10] This estimate is based on our own calculations, using the data in Azevedo, Inchausti, and Sanfelice (2012). See also Lustig, López-Calva, and Ortiz-Juárez (2013).
Given the importance of labor incomes, in particular for the poor, on the distribution of income, a number of studies have attempted to isolate the role that shifts in demand and supply have played in the changes in returns to schooling (Aedo and Walker 2012; Gasparini, Galiani, Cruces, and Acosta 2011; Manacorda, Sánchez-Páramo, and Schady 2010). These papers conclude that changes in the supply of workers with different amounts of education explain only a modest fraction of the changes in the skill premium observed in Latin America in the last three decades. Demand-side changes, in particular skill-biased technological change, substantially increased the wage premium for workers with more education (especially university education) in Latin America in the 1990s. However, for reasons that are insufficiently understood, the effects of these demand-side shocks appear to have petered out by the 2000s. Institutional changes in the labor market were also important. The real minimum wage has increased substantially in some countries—by more than 50 percent in Brazil and by 200 percent in Uruguay between 2004 and 2010. The minimum wage has been shown to be an important determinant of the distribution of earnings in some countries in the region (Aedo and Walker 2012; Bosch and Manacorda 2010; Maloney and Núñez Mendez 2004).

Of the various programs that directly redistribute resources to poor households in Latin America, the best known and most studied are targeted cash transfer programs, which were pioneered in the region and have become popular since the late 1990s. In these programs, eligibility is generally determined not by income directly, but by a composite measure of household characteristics, assets, and access to social services that are correlated with consumption or income. Some of these programs, but not all, are “conditional cash transfers” that require households to comply with a number of conditions in return for the cash—generally, preventive health check-ups for children and pregnant mothers and attendance at school for school-aged children. These conditional cash transfer programs are in some cases quite large. Table 1 shows that in 16 countries, average coverage is one out of every four households. Careful randomized evaluations of conditional cash transfer programs in Latin America have shown that they have substantially increased school enrollment and attendance, and preventive health care utilization (Fiszbein and Schady 2009, and the references therein). Children in beneficiary households complete more schooling—for example, Behrman, Parker, and Todd (2011) conclude that three years of PROGRESA transfers in Mexico result in approximately 0.3 more years of completed schooling (relative to no transfers). Conditional cash transfers have also had substantial effects on poverty and inequality.

While conditional cash transfers have clearly had overall positive effects, there are three main concerns. First, while cash transfer programs have increased school enrollment, the evidence on whether the additional schooling results in better learning outcomes for children who were brought into school by these programs

11 Skill-biased technological change may have been transmitted through trade (Sánchez-Páramo and Schady 2003). Other references include Acosta and Gasparini (2007), Behrman, Birdsall, and Székely (2007), and Galiani and Sanguinetti (2003).
is mixed. In Nicaragua, Barham, Macours, and Maluccio (2013) find that boys (but not girls) whose families received transfers from the Red de Protección Social program when they were between 9 and 11 years of age have test scores that are approximately 0.2 standard deviations higher ten years later; in Mexico, Behrman, Parker, and Todd (2009) find that children who received PROGRESA transfers do not have higher test scores than comparable children who did not receive them. Although the reasons for this finding are unclear, the poor quality of education and the fact that many of the children who were brought into school are drawn from the lower end of the distribution of ability are probably part of the explanation. Moreover generally, while conditional cash transfers have increased the utilization of health and educational services, impacts on final human capital outcomes have been more limited. As a result, the effect that conditional cash transfers have on reducing the intergenerational transmission of poverty—a key objective of these programs—may be limited (Levy 2007).

Second, the transfers may in some cases be so large that they can have a negative effect on incentives to work. Figure 5 presents the evolution of transfers for four of the biggest cash transfer programs in Latin America. In Ecuador and Mexico, transfers have increased substantially in magnitude. In Mexico’s PROGRESA, since renamed Oportunidades, transfers are now equivalent to over 40 percent of household pretransfer income in the lowest quintile of the distribution. Transfer income also represents a sizeable share of total income in Ecuador, where the program is also very large in scope, covering almost 40 percent of the population. If leisure is a normal good, we might expect that the income effect of transfers of this magnitude would reduce labor supply. Moreover, many of the cash transfer programs in Latin America periodically “recertify” beneficiaries to ensure that they are still poor, to qualify for continued eligibility. This obviously introduces an incentive for households to continue to be (or at least appear to be) poor. Camacho and Conover (2011) show that, once the exact formula used to calculate the proxy means test that determined eligibility for Colombia’s Familas en Acción program was made public, there was substantial heaping of households just below the cutoff value. In Chile (and in some other countries), having a household member with a physical

13 The evidence on this point from developing countries outside the region is also mixed. Filmer and Schady (2009) analyze the effect of a conditional cash transfer-like program in Cambodia. They find no effect of transfers on test scores, in spite of large effects on school enrollment and years of completed schooling. Baird, McIntosh, and Ozler (2011) analyze a pilot program in Malawi which randomly assigned children to conditional transfers, unconditional transfers, and a control group. The conditional transfer had a larger effect on school enrollment than the unconditional transfer, and the conditional transfer (but not the unconditional transfer) had a positive, but modest effect on test scores.

13 Results from early evaluations of conditional cash transfers in Latin America suggest that adults in recipient households generally did not reduce labor supply in response to transfers (Alzúa, Cruces, and Ripani forthcoming; Skoufias and Di Maro 2008; Parker and Skoufias 2000). It is not clear, however, whether these results hold for programs that have been in place for a decade or longer, and given that transfer amounts have increased. Indeed, the evidence on noncontributory pensions in Latin America, discussed above, as well as the ample literature on welfare programs in the United States, all suggest that reductions in labor supply are a real possibility.
or mental disability increases the value on the proxy means, and this is well known. Herrera, Larrañaga, and Telias (2010) show that, among the poorest households, almost 80 percent report having a household member with a disability on the 
\textit{Ficha de Protección Social}, the survey that is used to construct the proxy means. In comparison, on the national CASEN household survey, which does not determine eligibility for transfers, about 20 percent of the poorest households report having a member with a disability.

Third, conditional cash transfers can also favor informal over formal employment (in addition to the effects of contributory and noncontributory social insurance programs discussed earlier). The Uruguayan \textit{PANES} program explicitly disqualified recipients if their formal sector earnings increased above a predetermined value. Amarante, Manacorda, Vigorito, and Zerpa (2011) show that \textit{PANES} substantially reduced formal employment among men and that these effects persisted at least two years after the program ended.

Despite the amount of attention from academics and policymakers, neither cash transfers nor noncontributory pensions are always the largest programs that seek to redistribute resources to the poor in Latin America. In many countries, transfers to all households through subsidies to energy prices, or exemptions on consumption or value-added taxes on particular goods (usually food, medicines, or transport) absorb a larger share of the budget than either cash transfers or noncontributory social insurance, or both. In Venezuela, energy subsidies represent 6.9 percent of GDP; in Ecuador 6.4 percent; in the Dominican Republic...
5.5 percent, and in Argentina, 1.8 percent (International Energy Agency 2011). Exemptions from value-added taxes cost around 2 percent of GDP in Costa Rica, Mexico, Colombia, and Guatemala, 1.6 percent in Peru and Ecuador, and 0.8 percent in Argentina (Corbacho, Cibils, and Lora 2013). Because richer households spend more in absolute value on electricity, cooking oil, and gasoline as well as on tax-exempt goods like food and medicine, these subsidies and exemptions disproportionately benefit better-off households. In Mexico, the residential electricity subsidy is larger than the budget of Oportunidades, yet 57 percent of the electricity subsidy goes to households in the top two income quintiles, compared with about 6 percent for the lowest one. Universal subsidies and tax exemptions are very inefficient ways of redistributing resources to the poor.

In sum, about half of the reduction in inequality in Latin America in the last decade has occurred for reasons other than the expansion in the coverage of social programs. Declines in the returns to education and the resulting increase in the share of total labor income among the poor have been particularly important. However, social programs, especially conditional cash transfers, have also played a role. That said, and recognizing the variations across countries, the scope for additional redistribution through cash transfers or noncontributory pensions appears limited, because increasing the value of the transfers is likely to have increasingly negative effects on the labor supply of recipients, accentuate distortions between the informal and formal labor market, or affect incentives to save. This argument does not imply that the region should abandon efforts to further reduce poverty and inequality. Instead, it suggests that other policies are likely to be more effective in the future. At present, personal income taxes in Latin America are among the lowest in the world, collecting only 1.4 percent of GDP versus an average of 8.4 percent of GDP in developed countries (Corbacho, Cibils, and Lora 2013). Increasing tax revenues, particularly from higher-income households, would contribute to lower inequality. In parallel, the region could benefit from redirecting some of the resources now channeled through generalized energy subsidies and exemptions from value-added taxes to invest more in early childhood development, design effective labor training programs, or fund health and other components of social insurance for all workers, regardless of their labor status. These are all measures that would increase incomes, particularly incomes of poor households, via the route of higher productivity.

**Conclusions**

Although many factors have been at play, increased social spending and new social programs have helped to reduce poverty and inequality across Latin America. What accounts for these changes in social policy in the last two decades? We highlight three important explanations. First, the emergence of more democratic regimes in the 1990s renewed political pressures to respond to unacceptable levels of poverty and inequality, in particular after the “lost” decade of
the 1980s. Second, greater macroeconomic stability facilitated growth, providing fiscal revenues to increase spending (aided in some cases by favorable international conditions); it also allowed policymakers to focus on issues other than the latest adjustment program with the International Monetary Fund. Third, there was a recognition that traditional social programs had had only limited success. In contexts of high informality, contributory social insurance had failed to protect the majority of households from risks; in countries with high income inequality (that is, most of Latin America), generalized subsidies were mostly captured by higher income groups. Lessons from the past were converted into pioneering initiatives to provide households in the informal sector with health services (like Colombia’s Régimen Subsidiado) and pensions (like Brazil’s Previdência Rural); or to focus income transfers on the poor while turning them into investments in their human capital (like Mexico’s PROGRESA).

As a result of faster growth, more social spending and new programs, millions of Latin Americans are now eating better, attaining more schooling, enjoying improved access to health services, and having higher incomes during old age. The region’s “middle class”—those living in households with income per capita between $10 and $50 (in US dollars) per day—increased from 20 to 30 percent of the population between 1990 and 2010, and their share in national income increased from 40 to 50 percent (Ferreira, Messina, Rigolini, López-Calva, Lugo, and Vakis 2012). These economic and social developments offer a more fertile ground where the rule of law and stronger institutions can develop deeper roots.

Has a turning point been reached? Has Latin America put in place policies to sustain faster rates of growth and higher real incomes, based more on increasing productivity and less on the gains derived from macroeconomic stability and favorable Asian winds? Put differently, can the region in the next decades reach incomes per capita on par with, say, Korea, or rather will it be caught in a “middle income trap”—more stable and less poor, but not truly prosperous and equitable? On this key question, the jury is still out.

There is much that Latin America can and should do to build truly prosperous and equitable societies. Critically, in our view, the region needs to recognize that faster growth requires improved productivity, not just factor accumulation and favorable international conditions. In parallel, the region needs a deeper understanding of the factors limiting productivity growth and the policy reforms required to stimulate it. We believe that at present there is no consensus across Latin America that accelerating productivity growth is essential to achieving faster growth, and even less consensus as to what policies are needed to accomplish it. This situation stands in contrast with the consensus that emerged two decades ago that macroeconomic stability was essential to resuming growth, and that sound monetary policy and prudent fiscal management were needed to deliver stability.

What role does social policy play in all this? First and foremost, it should be concerned with raising social welfare. More educated citizens will result in a better informed electorate and, more generally, in improved institutions. Broader protections against risks and wider opportunities will help to reverse disparities that, sadly,
have for too long been Latin America’s trademark. But social policy, in our view, should also contribute to productivity growth, or at least not hinder it. In the end, one cannot sustain a welfare state on stagnant productivity, particularly since the costs of that welfare state will increase rapidly as the region’s population ages and its epidemiological profile evolves towards more costly pathologies. We want the humanistic and civic value of education, but Latin America also needs competent engineers, nurses, and computer programmers; we want protection against risks, but Latin America also need firms and workers that pay taxes, invest in labor training and innovate; we want less poverty, but Latin America also needs to avoid permanent welfare dependency and unduly reduced participation rates. Higher average per capita incomes are needed if only to provide the revenue base from which social programs can be financed—a key point in a region that in the past suffered much from unsustainable fiscal deficits.

Social policy needs to change because, as we have argued, at present it is only partly effective in reaching its direct objective of higher welfare, but also because it is making an insufficient contribution to productivity growth (and in some cases, is working against it). More particularly, social policy in Latin America needs to address four challenges. First, it needs to increase abilities among children and young adults, to create the skilled workforce that can support sustained productivity growth. Of particular relevance are interventions that seek to ensure that poor children do not fall behind at early ages in terms of their nutrition and cognitive and noncognitive development. Put differently, there is not enough “pre-distribution” (to borrow a term from Heckman 2012) in the form of investments early on. These early investments need to be followed with education that is of higher quality. The poor quality of teachers in many countries in Latin America requires better pre-service and in-service training. But, we believe, it also requires greater flexibility to reward good teachers and dismiss poor ones. In a recent paper on the United States, Rockoff and Staiger (2010) argued in this journal that, while teachers can improve learning outcomes, the observable characteristics of teachers (including degrees, test scores and experience, at least after the first two to three years) explain very little of the difference in their effectiveness. On this basis, Rockoff and Staiger propose a teacher selection system that requires few upfront teaching-specific investments, recruits widely, but gives tenure to only a very small minority of teachers. The conclusions of their analysis seem to us to be especially relevant for Latin America, where many teachers are ineffective but, thanks to very powerful unions in many countries, teachers often receive automatic tenure upon entering the public education system.

Second, the coexistence of contributory and noncontributory social insurance is only partly effective in protecting workers against risks and does a poor job in smoothing consumption between work and retirement. Moreover, the way in which social insurance is financed, including the use of cumbersome mechanisms to protect against the risks of employment loss, distorts firm and worker behavior, and may also decrease long-term saving. Much research remains to be done in this area, but these distortions could have substantial, negative
consequences for productivity in Latin America. Correspondingly, reforms in the design of these programs could offer substantial benefits. Attention needs to be focused on unifying the source of financing for health insurance; more generally, risks that are common to any form of employment should be financed from the same revenue source. Inefficient labor protection regulations should be replaced by proper unemployment insurance. A clearer distinction should be made between the two objectives of pensions: Avoiding old-age poverty (which can be ensured with a modest noncontributory pension that does not depend on whether a worker is in formal or informal employment, and may or may not be means-tested), and smoothing consumption between work and retirement (which will likely require reforms that seek to increase the coverage of the contributory pension system). Insofar as possible, pension programs should not distort labor–leisure and formal–informal choices, and should not discourage long-term saving in local currency.

Third, while direct income transfers are clearly part of an effective social policy, transfer programs have their limits. Indeed, over-reliance on cash transfers may hurt those that they are intended to help, and also depress productivity, if it lowers labor market participation rates, increases informality, and results in long-term welfare dependency. Conditional cash transfers have also been used as a way of protecting households from temporary shocks, even though it is not clear that they are the right instrument for this purpose. Many of the challenges faced by the current beneficiaries of conditional cash transfer programs are better addressed by policies that improve the quality of services and the functioning of labor markets. Given the coverage and transfer amounts in place in many countries today, further redistribution may be better accomplished by reforming personal income taxes, or by redirecting generalized subsidies embedded in energy prices and special tax regimes into investments in early childhood development, in labor training, or in improving the quality of health and education services.

Finally, Latin America needs to ensure that its social programs, including pensions, health care, cash transfers, and expenditures on education are fiscally sustainable in the long run, and are not vulnerable to the vagaries of international commodity prices. Governments should also make more explicit the link between contributions and benefits in all social insurance programs, as this will help address the political economy considerations that have driven the growth of benefits in noncontributory systems (Antón, Hernández, and Levy 2012).

The solutions to these problems are technically complex, and may need to be implemented in a global economic context that is less favorable than it has been in the recent past. But these complexities are dwarfed by the political challenges, as the needed reforms touch core fibers of the region’s social fabric: the relations between parents, teachers, and the government; subsidies and taxes; and the interactions between firms and workers in the labor market. The societal consensuses that, after many painful crises, were built around the importance of prudent macroeconomic policies need to be extended to areas where vested interests and strongly held beliefs make such consensuses more difficult to reach.
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