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Unemployment Insurance in Chile: A New Model of Income Support for Unemployed Workers

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SUMMARY

This paper describes the Chilean experience concerning the implementation of a new unemployment insurance (UI) program. The use of individual savings accounts and private management are essential elements. In addition, a redistributive fund (Common Fund) helps workers pool risks, distributing resources from employed to unemployed workers and from stable firms to workers with low incomes and unstable jobs. The combination of personal accounts and redistribution reduces moral hazard problems endemic to traditional UI schemes and keeps costs at manageable levels. The paper discusses the political, social, and economic context in which this program was enacted and implemented, it reviews its key characteristics, it assesses the initial performance of the system in terms of coverage and benefits and it assesses the challenges that lie ahead. Finally the paper discusses the potential of this system as a model for other middle- and low- income countries.

Keywords: Social Protection, Unemployment Insurance, Chile, Individual Savings Accounts.

JEL Classifications: J05, J32, J65.

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INTRODUCTION

Around the world, concerns over unemployment are fuelling an intense debate on how best to improve social protection instruments available to unemployed workers. Chile has a number of innovative programs that could be suitable to the reality of many developing countries. This paper describes the Chilean experience concerning the implementation of unemployment insurance (UI). The use of savings accounts and private management are essential elements of the Chilean system. In addition, a redistributive fund (Common Fund) helps workers pool risks, distributing resources from employed to unemployed workers and from stable firms to workers with low incomes and unstable jobs. The combination of personal accounts and redistribution reduces moral hazard problems endemic to traditional UI schemes and keeps costs at manageable levels.

The paper discusses the potential of this system as a model for other middle- and low-income countries. Since policymakers often face similar economic, political, and technical constraints, the Chilean experience may be valuable for other countries considering implementing unemployment insurance schemes. Schemes to protect workers against the risk of unemployment have attained prominence in Latin America and around the world. Unemployment was the main concern of Latin Americans in the 1990s, according to the Latinobarometro, a public opinion survey performed in the majority of countries of the region. This is not surprising, since unemployment rates increased and reached record highs

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toward the end of the decade. Moreover, the incidence of unemployment increased for all workers, regardless of age, gender, geographical location, or educational level.¹

A number of recent studies show that most market economies are subject to a large rate of worker and job reallocation, even in the formal sector.² This high turnover is driven by the constant process of learning and adaptation of firms to their environment. It is also driven by the inability of less productive firms to survive. This perennial process of creation and destruction reallocates workers from less productive to more productive uses and constitutes an important source of productivity growth. However, it also involves a large degree of risk, which may be difficult to diversify for workers with limited access to capital or insurance markets.

To cope with job turnover and unemployment, Chile has enacted a number of social protection instruments, such as public work programs, unemployment subsidies, and severance payments. Chile approved a comprehensive Unemployment Insurance law (UI) in 2002, after almost three decades since the first structural reforms. As of December 2005, 3.86 million people had enrolled in the program. Enrollment is compulsory for workers whose employment relations started after the enactment of the law (October 2002), and voluntary for workers whose contracts started before that date.

The design of Chilean unemployment insurance took into account international experience concerning the design and implementation of UI, as well as years of experience managing individual capitalization accounts.³

The rest of this paper examines the program and the political, social, and economic context in which it was enacted and implemented—with lessons for other countries. The second section of this paper describes key characteristics of the Chilean labor markets and reviews income support policies available to the unemployed. The third section describes the essential features of the Chilean UI system and the political and economic environment in which it was developed. The fourth section describes the initial performance of the system in terms of coverage and benefits. The fifth section analyzes some of the challenges that may lie

¹ See Duryea, Jaramillo, and Pagés (2002).

² See Davis and Haltiwanger (1999); IDB (2003) World Bank (2005)

³ Chile switched from a pay-as-you old age pension system to an individual capitalization pension system in 1981. In the new system, monthly contributions are deposited in individual accounts managed by private administrators.

ahead in the implementation of UI in Chile and discusses the merits of the system as a model for other low- and middle-income countries. The sixth section provides some conclusions.

A BRIEF REVIEW OF LABOR MARKET CHARACTERISTICS AND INCOME SUPPORT POLICIES IN CHILE

The Chilean Labor Market

Chile has been the fastest growing country in the Latin America and Caribbean region and one of the fastest growing countries in the world, with an average annual growth rate of per capita Gross Domestic Product (GDP) of 4 percent from 1990 to 2004. GDP per capita, adjusted by purchasing power parity (PPP), jumped from \$5,861 in 1990 to \$9,993 per capita in 2004.⁴

At the end of the 1990s, deterioration in the terms of trade and external demand (as measured by trading partner GDP growth) resulting from the Asian Crisis, slowed down economic growth and led to an increase in the unemployment rate. The share of unemployed in the labor force rose to an average of 8.3 percent in 1999, up from 6.1 percent in the previous year and 7 percent in the previous five years. While economic growth recovered to 6.3 percent in 2005, unemployment remains stubbornly high, averaging 8.9 percent since 1999. The surge in unemployment rates at the end of the 1990s rekindled the debate on how best to protect workers against the risk of unemployment.

While a large proportion of the national labor force consists of salaried workers (64 percent), 24 percent of the workers are self-employed, and 8.5 percent are either unpaid workers or work as domestic helpers (INE 2004). Among salaried workers, 79 percent were hired with a permanent contract and the rest were employed in fixed-term or temporary jobs (CASEN 2000) About a third of urban employment (35.8 percent) in 2003 was informal, according to the ILO.⁵ Such characteristics present important challenges for the design of income support policies, as informal salaried workers, temporary employees, and the self-employed tend not to participate in mandatory contributory programs.

Some other important characteristics of the Chilean labor market are the noticeable increase in the share of employment in services in the last 15 years (from 55.5 percent in

⁴ GDP per capita, PPP constant 2000 international \$ dollars (World Development Indicators, April 2006).

⁵ ILO (2005).

1990 to 62.5 percent in 2002), and the large concentration of employment in the Santiago area, which accounts for more than 43 percent of total employment. Another feature is the low rate of female participation by international standards. Only 35.7 percent of working age women participate in the labor market, according to the latest figures (INE, July–Sept., 2004).

Income Support Programs for the Unemployed

Even before the introduction of UI, Chile had a number of policies and programs aimed at protecting workers against the risk of unemployment.

Severance Payments

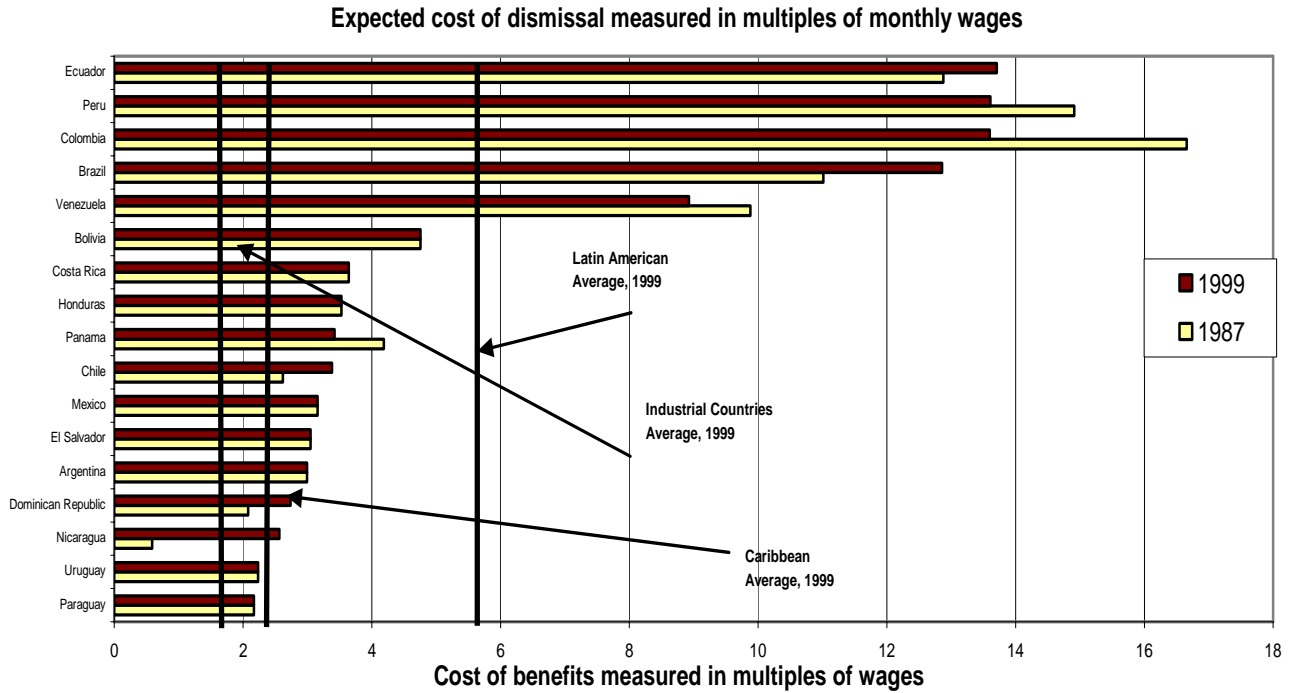
Mandatory severance pay and other employment protection mechanisms have been traditional instruments to protect formal employees against the risk of unemployment. The protection comes from two sources. Mandatory severance payments reduce the risk of unemployment by making dismissals more costly to employers. They also insure workers against the loss of income associated with unemployment by transferring resources to unemployed workers.

Mandatory severance pay amounts to one month of pay per year of work up to a maximum, which can be increased by collective bargaining. This maximum level was increased in the early 1990s from five to eleven months of pay. While expected severance payments in Chile are below the mandated level in other Latin American countries, they are still well above the average for OECD countries. Figure 1 shows the expected costs associated with dismissal in a number of Latin American countries, as well as the industrial country average.⁶ Only workers laid off for no fault of their own are entitled to such payments. Neither workers with fixed-term, temporary contracts nor workers who quit their jobs are eligible. This greatly reduces the coverage in the total pool of unemployed.

⁶ See Heckman and Pagés (2004) for a description of how these costs are computed.

FIGURE 1. Cost of Dismissal, Latin America and the Caribbean and Industrial Countries

Note: Expected cost of dismissal measures in multiples of monthly wages. Cost of job dismissal includes advance notice plus indemnities for dismissal plus seniority pay.



Source: Heckman and Pagés (2004)
 Cost of Job security includes advance notice+Indemnities for dismissal +Seniority Pay

A number of negative effects of severance payments and other forms of employment protection have been documented in the economic literature. Employment protection reduces the ability of firms to adjust employment to changes in economic conditions. It reduces job destruction but also inhibits job creation (Bertola 1990). The result is higher job stability—but also higher duration of unemployment (Nickell 1997). Employment protection has also been shown to reduce employment opportunities for youth, women, and unskilled workers relative to middle age males.⁷ The evidence on employment and unemployment levels is less conclusive, but a significant amount of research suggests that employment protection reduces employment and increases unemployment (see, for instance, Saavedra and Torero 2004;

⁷ See Montenegro and Pagés (2004) for Chile, or Nickell (1997) and Bertola, Blau, and Kahn (2002) for industrial countries.

Besley and Burgess 2004). Finally, there is mounting concern that restrictions on employment creation and destruction may inhibit productivity growth (see, for instance, Caballero, Engel, and Micco 2004; and Caballero and others 2004). This evidence is based on the finding that across the world, reallocation of jobs from less productive to more productive firms is responsible for a large share of total productivity growth. Therefore, policies that inhibit turnover may also have a detrimental effect on productivity.

Another problem associated with severance payments is that they are due in periods when firms are in distress. This implies that, in many cases, severance payments are not paid because firms go bankrupt. Severance payments are also more likely to be received by workers who have higher ability to withstand long judicial processes to collect benefits. For all these reasons, severance pay is a problematic mechanism to reduce the income risk associated with unemployment

Unemployment Subsidy

This subsidy was initiated for salaried employees in 1936. It is now being phased out and will be terminated when all eligible workers are covered by the new Unemployment Insurance scheme. It was a noncontributing system that paid low absolute monetary benefits (from US\$12 to US\$25 per month) for a maximum of 12 months. The government provided these benefits to involuntarily unemployed workers who were registered in a municipal employment office and had worked for at least 12 months during the prior 24 months. The fiscal cost of this program was approximately US\$10 million a year, which implied an annual average benefit of US\$200. In 2001, a period of high unemployment, only 10 percent of those actively searching for a job were covered by the program (Vroman 2003). The resources that funded this program are being allocated to the new UI system.

Workfare Programs

Workfare programs have been the method of choice to provide jobs and income to low-income workers in periods of low economic activity. The government provides monetary resources to households in exchange for work in public works. The duration of these programs is between three and six months.

Salaries paid at the minimum wage level have reduced the effectiveness of the work requirement as a targeting device. The discretionary nature of the programs has presented problems. Moreover, the rushed implementation of such programs in times of crisis prevented them from attaining an optimal design, both in terms of implementation and from the point of view of identifying which programs maximize labor intensity while still producing public works that meet standard levels of quality.

Hiring Subsidies

Employment subsidies aim at increasing firms' incentives to hire workers in private sector jobs in periods of high unemployment. In the last episode, which was triggered by the economic slowdown that followed the onset of the Asian Crisis, employers received a subsidy of 40 percent of the minimum wage for each worker hired for a period of four months. In addition, the firm received a lump-sum payment for training. The government financed the creation of 100,000 to 150,000 jobs. As with workfare programs, there is no pre-established trigger to initiate or phase out hiring subsidies, but rather, a discretionary decision by the government. The cost of this program has been high (about \$US 60 million) and reports of fraud have been widespread. They range from the creation of ghost enterprises, employers that hired deceased people, or firms that fired and re-hired workers to benefit from the subsidies. Such problems highlight the difficulties inherent in administering this type of programs: difficulties that also arise in high-income countries

Unemployment Insurance for Domestic Helpers

This mechanism, created in 1991, aims at protecting domestic helpers against the risk of unemployment by means of mandatory individual unemployment insurance savings accounts. Employers deposit 4.11 percent of the monthly wage of a domestic helper in his or her account. At the end of the employment relation, independently of the cause for termination, workers can withdraw the accumulated balance. A major problem is that workers tend to keep balances very low by withdrawing balances once a year in agreement with employers.

Job Search Assistance

In Chile, job search assistance has been delivered through a combination of a weak public system and some private providers. The public system is based in the municipalities, which voluntarily decide whether to create a job search assistance center or not. Until two years ago, each center had its own database of local vacancies and job seekers and matching was performed at the local level. This limited geographic coverage reduced the efficiency of the matches. Only 70 percent of the vacancies listed by the intermediation agencies could be filled. In the rest of the cases, suitable candidates could not be found at the local level.

A recent innovation is the constitution of a single national registry of vacancies, developed through a partnership between private and public institutions. This registry is also being linked to the new UI system, so that each time a worker files for UI benefits he/she appears in the list of job seekers. However, linkages with training providers and other income protection services for the unemployed have remained limited.

It is clear that the system of programs and policies to cover the risk of unemployment described above suffered from *weak targeting, low coverage, poor control and monitoring* by the State, and *fiscal constraints* that arise because expenses increase in recessions, just when the State also runs into budget difficulties. In addition, some components, such as severance payments, may cause important adverse effects in the labor market. The new unemployment insurance law described below is an attempt to face up to some of these weaknesses.

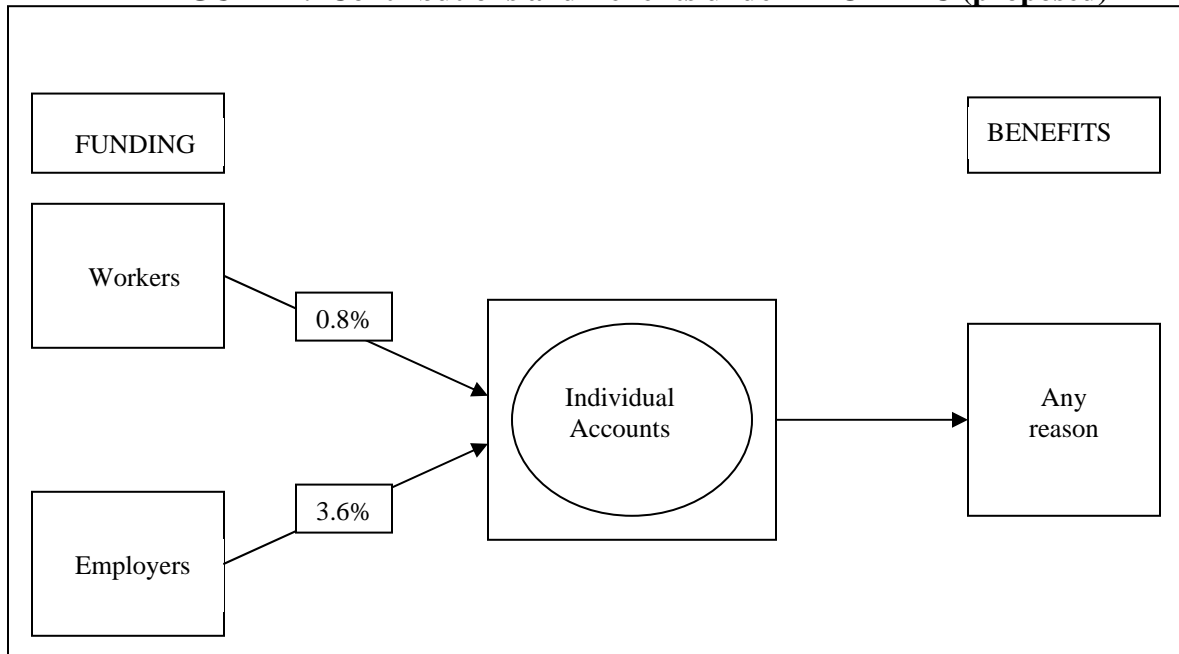
CHILEAN UNEMPLOYMENT INSURANCE

Political Context

After 17 years of dictatorship, democracy was restored in Chile in 1990. Since then, the party in government has been a political coalition of center and left-wing parties, which have as priorities improving workers' bargaining strength and social protection schemes. The coalition had sent a number of proposals to Congress to create an unemployment insurance program as a way to improve upon the existing income support programs for unemployed workers.

The initial proposal, named PROTRAC (protection for laid-off workers), if approved, would have been funded with employers' and workers' contributions to wages, according to the following schedule: 3.6 percent of wages for employers, and 0.8 percent of wages for workers (see figure 2). The government would have ensured a minimum level of benefits to workers who contributed for at least 12 months. Workers who did not have enough funds in their accounts to finance the minimum level of benefits would have received a transfer from the government equal to the minimum monthly benefit minus the funds accumulated in the account. Only workers who were involuntarily dismissed for no fault of their own qualified for government transfers. Temporary workers were excluded, and many fund managers would have competed for individual accounts.

FIGURE 2. Contributions and Benefits under PROTRAC (proposed)



This project was discussed for more than four years, but no agreement was reached in Congress. Workers' representatives regarded the benefits as too low, while employers regarded the system as too expensive. Ultimately the proposal failed for the following reasons:

- *Insufficient benefits:* The benefits provided by PROTRAC were only marginally higher than benefits provided by the unemployment subsidy.
- *High employers' contributions.*
- *High and countercyclical fiscal costs:* PROTRAC did not consider creating a fund to pay workers with insufficient balances in their individual accounts. Thus fiscal outlays would have increased substantially in times of high unemployment, when the State also runs into budget constraints.
- *High administrative costs:* The proposal relied on private account managers who would compete, reducing their fees to capture customers. Yet the Chilean pension system demonstrates that administrative costs can be quite high, particularly for low-balance accounts. Given the average balance held in a typical individual UI account, it was estimated that the management of each individual account would cost around US\$1 per month. Considering that the minimum wage in Chile at the time was US\$120 per month, the administrative costs would have been equivalent to more than 20 percent of each contribution, which was unacceptably high.

From PROTRAC to the UI Law

Despite the failure of PROTRAC, the government persisted in its efforts to set up an unemployment insurance system. Various factors contributed to the final acceptance of the unemployment insurance law, which was approved in Congress in 2001 with a remarkable political consensus and a high quorum (over 90 per cent in Congress and Senate).

1. *Business cycle.* When the first PROTRAC proposal was drafted, unemployment in Chile was low and the labor market was reaching full employment. Yet at the end of the 1990s, a deterioration in the terms of trade and external demand led to an increase in the unemployment rate. This surge rekindled the debate on how best to protect workers against the risk of unemployment.
2. *Political timing.* PROTRAC was discussed at the end of a political term with a government weakened by the negative economic impact of the Asian Crisis. In 2000 a new government made the approval of the UI system a priority.

3. *Social consensus.* The objective of PROTRAC was to reduce the welfare cost of labor reallocation. The new UI proposal emphasized protection against unemployment in a context of high and growing unemployment. The new proposal contemplated a phased-in approach, by which only new hires were mandated to enroll (while enrollment would be voluntary by workers with ongoing employment contracts). A gradual approach facilitated the buy-in of the workers more likely to receive severance payments, as well as of firms with stable labor forces. It also eased the fiscal costs for the State in the first few years, as the fiscal contributions would gradually increase with the number of enrolled workers. Unfortunately, to harness the support of workers' representatives, the proposal contemplated only a partial reduction of the costs of severance payments in exchange for new unemployment benefits—which, at least in the short run, implied higher labor costs for firms.⁸
4. *Universality.* The initial PROTRAC proposal considered protection only for permanent workers. The exclusion of temporary workers was opposed by representatives from rural areas, with high incidence of temporary work in agriculture. The new proposal extended coverage to temporary workers.
5. *Autonomy.* To prevent the use of funds collected through contributions to unemployment insurance for other uses, the proposal included the creation of an autonomous institution legally separated from the State that would be in charge of collecting resources, administering the program, and paying benefits. The right to collection, administration, and payment would be auctioned to a sole provider. Thus, instead of having multiple fund administrators competing *in the market*, the proposal contemplated competition *for the market* as a way to reduce the high administration fees associated with low balances. Such lower fees allowed employers' contributions to be lower, which won over the support of firms.

⁸ An increase in the overall contributions to income support programs does not necessarily mean an increase in labor costs for firms since wages may adjust downward to compensate for higher in-kind benefits. Nonetheless, such adjustments are likely to take time; therefore, higher contributions are likely to increase labor costs in the short run.

Main Features of the Chilean System

The main features of the Chilean unemployment insurance system are as follows:

Individual Savings Accounts plus a Common Fund

The unemployment insurance in Chile is based on two components. The first component takes the form of self-insurance by means of individual savings accounts. A fixed percentage of workers' wages is deposited in workers' individual accounts. These funds plus their returns can be withdrawn according to a predetermined schedule at the end of the employment relationship. In designing the current unemployment insurance scheme, Chile's ample experience in dealing with individual capitalization accounts played an important role. Chile has more than 20 years experience with such arrangements through its private capitalization pension plan.

The second component of the program is a subsidy paid out of a *Common Fund* built with a portion of firms' contributions plus direct contributions from the State. This subsidy aims to provide funds to those unemployed workers who do not have enough funds saved to cover a predetermined schedule of withdrawals, given their earnings or employment histories.

Coverage

The unemployment insurance covers all enrolled workers over 18 years old who are employed in private sector salaried jobs. Workers under 18 years old, the self-employed, and domestic service workers are excluded from this system. Young workers are excluded to avoid creating incentives for quitting school. Domestic service workers are excluded because they have a separate unemployment insurance system. Public servants are excluded because of their low risk of becoming unemployed. Temporary workers are included in the system: a notable improvement in coverage compared with typical UI schemes. Their inclusion is possible because of the unemployment insurance savings accounts (UISA) component.

Enrollment

Participation in unemployment insurance is compulsory for all employees who started a new job after October 2002, and it is voluntary for those workers who were already employed at that time. The obligatory nature of this system avoids the problem of adverse selection that arises when only workers with high risk of unemployment join the system. The gradual approach, however, implies strong adverse selection at the start of the program, until all workers are enrolled. Thus workers with higher turnover and higher probability of unemployment are the first to enroll because they are more likely to transit from job to job, or from unemployment to employment.

Nonetheless, a gradual approach allowed policymakers to achieve two desirable objectives. It reduced employers' opposition because of new unforeseen costs associated with UI. It also provided time for the economy to absorb this new labor cost.

Contributions

UI is funded by three actors: workers, employers, and the government. Workers and employers contribute a given proportion of a worker's salary. The government contribution is a direct, predetermined amount fixed by law. The amounts contributed by the different actors depend on whether workers are employed in temporary or permanent jobs.

Employers of permanent workers contribute 2.4 percent of wages to the UI program. Out of this, one-third of the contribution, or 0.8 percent of wages, goes to finance the *Common Fund*. The rest (1.6 percent of wages) is deposited in workers' individual accounts. For their part, workers contribute 0.6 percent of their wages (see figure 3). The government contribution to the Common Fund amounts \$US10 million per year (fixed in real terms). Temporary workers do not have access to the benefits provided by the Fund. Thus contributions from the State benefit only permanent workers. In the case of temporary workers, the employer pays a contribution of 3 percent, which is entirely deposited in the worker's individual account (see figure 4). The maximum period of uninterrupted contributions is not 11 years, after which, employers nor workers are obliged to contribute.

FIGURE 3. Contributions and Benefits for Permanent Workers

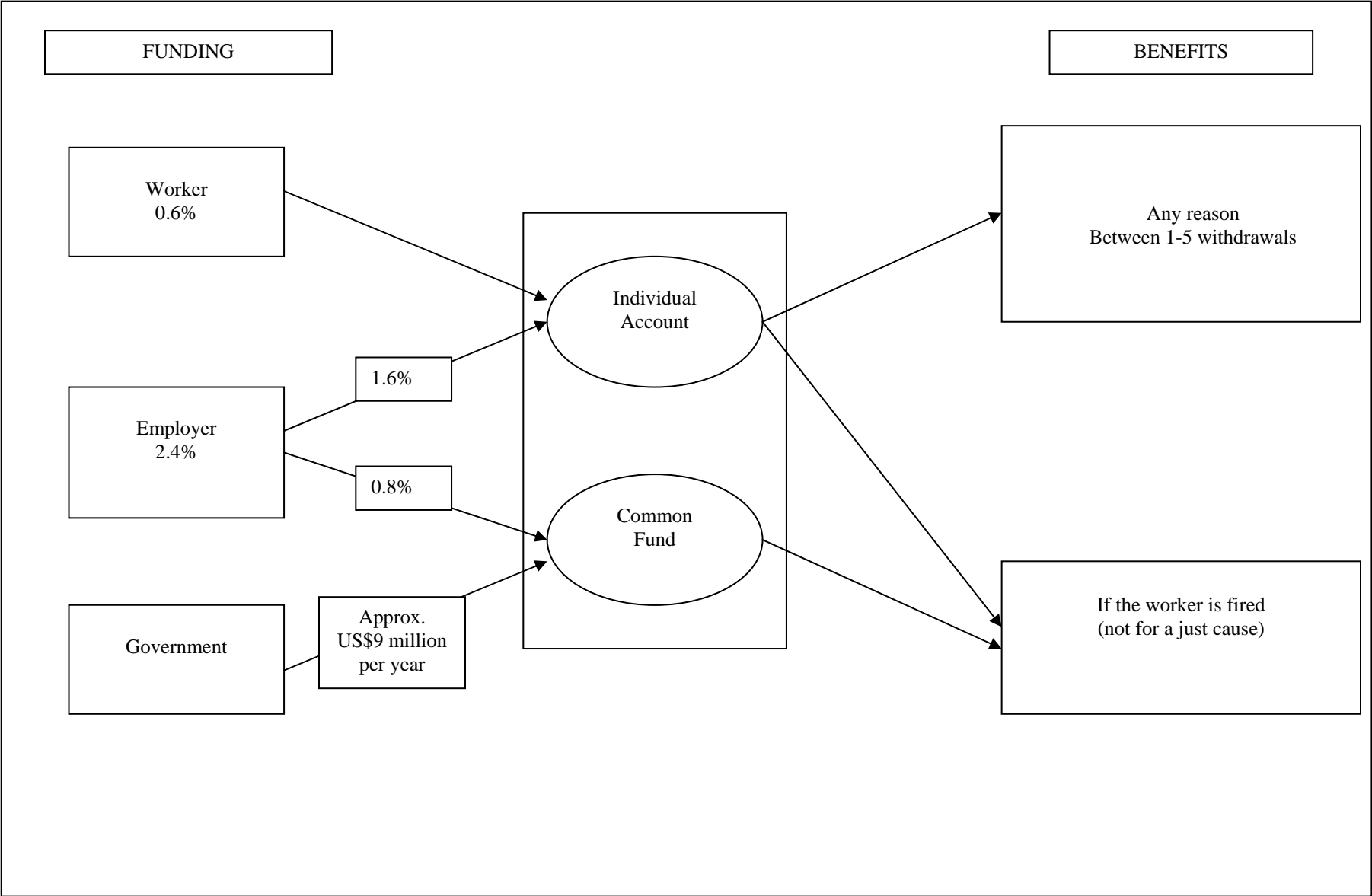
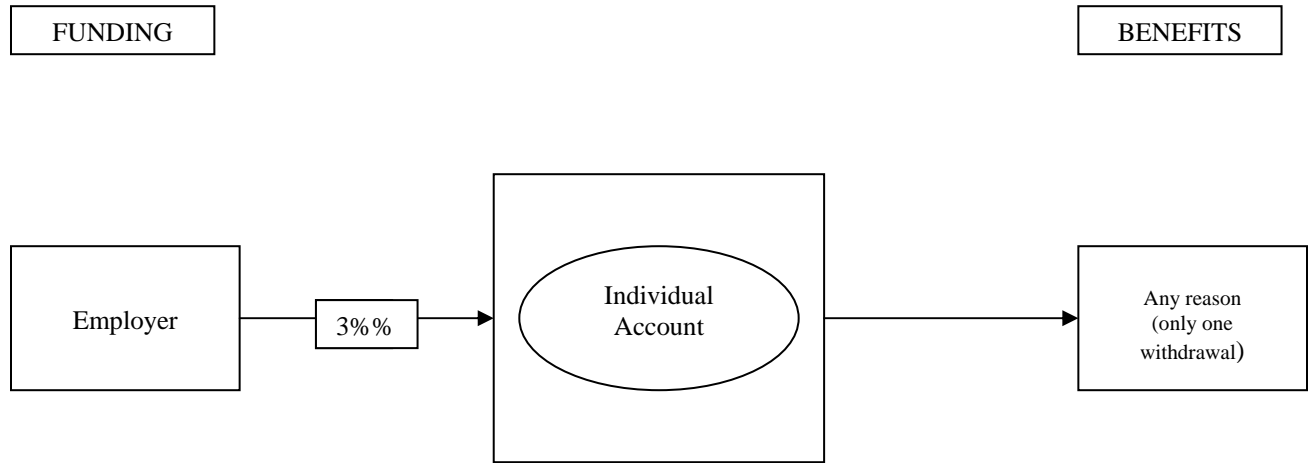


FIGURE 4. Contributions and Benefits for Temporary Workers



Benefits

Benefits from Individual Savings Accounts

Because savings in the UISA are the property of workers, they can be withdrawn independently of the type of contract or the reason for termination of the employment relation. However, eligibility criteria and the timing of benefits differ depending on whether worker are permanent or temporary. The minimum contribution period to receive these benefits—that is, to be allowed to withdraw funds from the account if unemployed—is six months for temporary workers and twelve months for permanent ones.

Workers with temporary contracts obtain access to their entire accumulated resources in the first month after unemployment. In contrast, permanent workers can access their accounts for a maximum period of five months, according to a predetermined schedule of withdrawals and eligibility criteria. The number of withdrawals depends on the number of years of contributions. Each year of savings entitles permanent workers to one month of benefits. Workers can exhaust all the available resources in their individual accounts during a period of unemployment. Workers with fewer than 18 months of contributions can withdraw all their funds at once. In contrast, workers who qualify for more than one payment are entitled to a first payment computed by dividing the accumulated balance in their individual account by the factor reported in table 1. The second, third, and fourth payments are equal, respectively, to 90 percent, 80 percent and 70 percent of the first payment, computed as

indicated above. Workers entitled to five payments can withdraw the funds left in their accounts. The estimated replacement rate of benefits is reported in table 2.

Table 1. Factor to Compute First Payment

Eligible number of payments	Factor
2	1.9
3	2.7
4	3.4
5	4.

Source: Unemployment Insurance Law, April 19, 2001.

Table 2. Replacement Rate

Payment	Rate (percent)
First	37
Second	33
Third	29
Fourth	26
Fifth	22

Source: Authors' calculations based on assumed 4.4 percent annual rate of return and no growth in wages.

Benefits from the Common Fund

This fund ensures a minimum level of benefits for permanent workers whose accumulated funds cannot finance the full schedule of withdrawals described above, but who have contributed for at least 12 consecutive months to the program. At the beginning of an unemployment spell, workers who are eligible for this benefit opt between withdrawing funds from their accounts according to the scheduled detailed in table 1 or obtaining the schedule of benefits indicated in table 3. In the latter option, benefits are first deducted from the existing balance in the accounts. Once the account is exhausted, the benefits are paid out of the solidarity fund.

Table 3. Benefits from the Common Fund

Months	Benefits (%of average salary of previous 12 months)	Higher value (US\$)	Lower balue (US\$)
First	50	216	112
Second	45	194	93
Third	40	172	79
Fourth	35	151	66
Fifth	30	129	52

Source: Unemployment Insurance Law, April 19, 2001.

Note: Exchange rate = 580 \$/US\$.

Only workers who have been dismissed for no fault of their own can access these benefits, which start at 50 percent of the average salary over the prior 12 months and decrease 5 percentage points each month, down to 30 percent in the fifth month. The law also establishes lower and higher values for the absolute amounts paid (see table 3). Maximum and minimum floors are updated according to changes in the consumer price index. Workers cannot withdraw resources from the Common Fund more than twice in a period of five years.

There are built-in provisions to preserve the financial stability of the Common Fund. The total amount of payments in a month cannot exceed 20 percent of the value of accumulated funds.

Reduction of Severance Payments

An important design feature of the unemployment insurance program in Chile is that in the event of a worker's dismissal, employers can deduct the contributions made to that worker's individual savings account from any legal mandatory or voluntary severance payments owed to that worker. For example, consider a worker who has been employed at a firm for four years before being dismissed for no fault of her own. The legal mandatory severance pay is 30 days per year of work, but the employer can deduct all contributions to the worker's personal account plus the interest gained. Since the monthly contribution is 1.6 percent, it yields approximately a 20 percent a year, or a six –day, reduction of the total severance pay. Consequently, severance payments are reduced from 30 to 24 days. This

partial substitution between severance pay and unemployment insurance has reduced the impact of the UI program on labor costs.⁹

Private Management and Legal Monopoly

A private firm is in charge of managing the resources accumulated by the system. It has six main objectives: to collect contributions, credit individual savings accounts, (invest the resources in the financial market, verify eligibility criteria, pay benefits, and pursue debtors.

The management of the resources was auctioned to the firm that agreed to charge the lowest administrative fees for 10 years. The annual commission charge by the firm administering the management of the system is 0.6 percent per year, computed on the total amount of accumulated resources, including the Common Fund. This sum is charged exclusively to workers who are contributing. The law explicitly prohibited charging fixed commissions, as well as charging commissions related to contributions. The experience with the management of pension funds indicated that commissions on wages do not generate incentives to obtain higher profitability or increase the size of the fund. Commissions on the total accumulated resources also give the right incentives to the administrator not to overpay, since outlays reduce accumulated funds.

The auction process also set minimum levels regarding the quality of service related to such factors as geographic coverage, payment systems, and waiting times. Bidding companies were also allowed to propose additional services that they would perform for the same stated price.

In addition, to enhance scale economies, the administrating firm was allowed to contract out activities to other providers, such as customer service, collection of contributions, and database management. At present, the unemployment system has more than 400 agencies throughout the country, reaching around 90 percent of the territory. Only 35 people worked for the administrating firm, of a total of 2,000 workers who are involved in the system.

⁹ However, while severance payments are paid only in the event of dismissal, contributions to the unemployment fund are paid unconditionally. As discussed below, this feature is likely to lead to a significant increase in labor costs unless wages adjusted downward to compensate for the increase in benefits.

As with individual pension accounts, both the UI funds and the Common Fund are separated from the assets of the managing firm. Thus in case of financial failure, the workers' resources would not be affected. The fact that resources are separated from the State reduces the risk of "political capture": a situation that has occurred repeatedly in many developing and developed countries.

Resources in the individual savings accounts, as well as in the Common Fund, are invested in financial markets. The portfolio is completely (100 percent) made up of fixed income instruments. The superintendence of Pension Funds regulates the limits of investment. Only a fraction of this money can be invested abroad, and the concentration of investments is very restricted. The average duration for each instrument is required to be less than two years. The main goal for these regulations is to reduce the risk of the portfolio and to minimize the cyclicalities in the returns.

Every month that the profitability of the funds is above (below) the average of the three best (worst) performing fixed income instruments, the commissions can be increased (decreased) by 10 percent of the base rate or up to 50 percent of the change in profitability, whichever is smaller.

Finally, an important element of the private administration is that the private manager is responsible for incorrect payments. If funds go to some beneficiary who should not have received them, the administrator is responsible for reimbursing such resources to the Common Fund. This reduces the scope for overpayments and abuse, which consume a substantial amount of resources in traditional UI systems.

User's Commission

The UI law created a commission staffed by three representatives of workers and three representatives of employers, and chaired by an academic. Each member can serve for a maximum of three years in his or her post. The commission oversees procedures to ensure prompt payments and control of eligibility criteria. It also monitors the instruments and policies followed by the administering company and makes sure it abides by the terms of the contract. It has direct access to information and can make recommendations to the Pension Fund superintendence and the government.

Fraud Control

There are additional requirements to restrict abuses in the use of the Common Fund and encourage active job search by the unemployed. Recipients of Common Fund subsidies must be available to start a new job offered by a public employment office (called OMIL), which is in charge of maintaining a register of vacancies and unemployed workers.

COVERAGE and BENEFITS

As of December 2004, only 27 months after the program had started, 3 million workers—or 83 percent of the salaried labor force—were already affiliated with the UI scheme. However, not all affiliated workers contributed regularly. The ratio of contributors to affiliated workers in that same period was 54 percent.

The relative quick pace of incorporation to the UI scheme is a reflection of very high rates of worker turnover, since only 2.6 percent of the affiliates have affiliated voluntarily. The rest affiliated because they had started a new employment relationship. The gradual incorporation of workers, combined with high employment turnover, implies that in the first years, the sample of workers affiliated with the UI scheme will not be representative of the overall labor force. Instead, it will tend to over-represent worker who are more likely to experience job changes and spells of unemployment or inactivity.

The profile of the contributors confirms the differences between these workers and the total salaried labor force. While about 51 percent of the contributors were workers in temporary and fixed-term contracts, the proportion of temporary workers in the salaried labor force is 16 percent, according to the CASEN (2000). It is expected that the proportion of permanent workers affiliated to UI will increase over time, once the entire salaried labor force is covered.¹⁰

Women, youth, and less educated workers are overrepresented in the sample of affiliated workers, relative to the sample of active contributors or the total labor force. At the end of July 2004, women constituted 39 percent of the affiliates, while more than 50 percent of affiliates were between 18 and 34 years old. Their proportions in the labor force were 29

¹⁰ The CASEN is a household survey performed once every two to three years on a nationally representative sample of households.

and 36 percent, respectively. By skill level, 29 percent of the affiliates had completed only primary education, and 44 percent had completed high school, compared to 24 and 44 percent, respectively, in the total labor force. Disaggregating by sector, workers in agriculture, construction, finance, and professional services were overrepresented in the total of affiliates and contributors relative to the labor force, while workers in industry, social services, and transport were underrepresented. This suggests that the latter sectors are more stable. Lastly, the profile of affiliates by income level indicates that, so far, affiliation tends to be higher among workers with relatively lower earnings.

As of December of 2004, the UI system had paid benefits to more than 500,000 people, 93 percent of whom were temporary workers. The average benefit received by temporary and permanent workers was US\$103 and US\$160 (60,000 and 92,000 Chilean pesos), respectively. Most workers access benefits because of the employment relation is terminated, while only a minority got theirs because they quit. As of July 2004, only 1 percent of the total payments were made against the Common Fund.

A SUITABLE DESIGN FOR LOW-INCOME AND MIDDLE-INCOME COUNTRIES?

A Second Generation Program

The Chilean UI combines two sources of valuable experience in the design of income protection mechanisms: the ample experience with UI in developed countries, and the Chilean know-how in managing compulsory savings accounts. As such, the system may be considered as a part of a second generation of programs that seeks to redress some of the pitfalls encountered in the UI systems of industrial countries, while adapting to the characteristics of a middle-income country.

Typically, UI programs in industrial countries are based on pooling contributions from employers and employees—and in some cases the State—to pay a transfer to unemployed workers. Abundant research has showed that when funds are awarded from a collective fund, workers and employers have an incentive to overuse the system. On the one hand, firms may dismiss workers more often than they would if the UI system was not in place. On the other hand, workers may be less willing to accept job offers or to relocate where jobs are abundant. Numerous studies show that UI tends to increase the duration of

unemployment and fosters or accentuates problems of long-term unemployment. The strong incentive to abuse the system implies that countries either put in place sophisticated control mechanisms to reduce misuse or instead face large expenditures. Both options tend to be beyond the reach of developing countries, which is why so few developing countries implement traditional UI.

Moral hazard problems like the ones described above disappear when the funds belong to the worker. In the Chilean system, incentives to actively search for jobs and accept job offers are preserved because workers own their personal accounts.

However, while systems based on saving accounts eliminate problems of moral hazard, they are likely to provide insufficient insurance to workers who did not accumulate enough funds in their accounts. As in the Chilean pension system, the individual capitalization pillar is complemented with a redistributive pillar that transfers resources to workers with insufficient funds in their accounts.

The existence of the solidarity pillar brings back moral hazard problems. However, they are kept manageable by four factors. The first is that tying the right to get benefits from the Common Fund with the right to receive severance payments eliminates the incentives for firms and workers to collude and misrepresent the cause of termination. The second factor is that workers do not have access to the transfer from the Common Fund until they have depleted their accounts. So the first payments always come from their own resources. This preserves incentives to find jobs quickly, before funds are exhausted. The third factor is that the private administrator has incentives to pay only eligible workers. This is because any erroneous payments must be reimbursed to the Common Fund. In addition, more outlays imply less accumulated funds and lower commissions. Finally, the level of benefits is kept low and the duration is limited to five months. Studies assessing the optimal design of unemployment insurance have emphasized the importance of providing benefits for a limited duration and declining over time as key to preserving search incentives (Hopenhayn and Nicolini 1997). Based on these insights, transfers paid out of the Common Fund are short-lived and decrease over time, ameliorating possible disincentive and cost problems associated with traditional UI.

A second valuable source of experience comes from the Chilean experience in the administration of an individual capitalization pension system. In particular, it is becoming evident that the market of pension funds is characterized by economies of scale and low sensitivity to differences in returns. Both factors conspire to keep the number of providers low and for providers to behave in a noncompetitive manner. This results in large administration fees and lower returns for account owners. The Chilean UI system took these constraints into account by promoting competition *for* the market, rather than hoping that competition *in* the market would bring fees down.

Challenges

While the Chilean UI system provides many innovative features, its performance has not yet been evaluated. Therefore it is difficult to assess whether it can meet its promises in a cost-effective manner. One important limitation is that the program did not allow for evaluation from its inception. Thus, no baseline measure and no control and treatment groups were established to assess: whether workers with UI are able to smooth unemployment risk significantly better than workers without UI; whether workers entitled to the Common Fund take longer to find jobs than workers without UI or workers who draw funds only from their individual accounts; and whether workers with access to UI find better jobs than workers without UI. An experimental evaluation approach could have been carried out, for example, by starting the program at different times across different regions. This would have facilitated comparisons between the behavior and welfare of workers with the same tenure, with and without UI, before and after the introduction of the system. Mandating compulsory participation in the program for workers of a certain age group (for example, 35 and below) in addition to new entrants would have provided additional ways to compare the performance of similar workers (34 to –35-year olds versus 36 to –37-year olds) who were assigned randomly in and out of the program. Some attempts to study these questions can be undertaken with existing sources of household survey data, but the results of such *ex post* evaluations are less credible and therefore more subject to speculation than those obtained from randomized evaluations.

Possible shortcomings that will require close follow-up in the near future include the following:

- *Possible low coverage of the Common Fund.* During its first year, the Chilean unemployment insurance system gathered relevant information in relation to job creation and destruction. Preliminary data show that, at least for a share of the Chilean labor force, turnover is extremely high. This implies that it may be very difficult for many workers to achieve 12 consecutive months of contributions, reducing the coverage of the program.
- *Insufficient insurance for long-term unemployed workers.* The benefits awarded by the Common Fund may provide insufficient insurance to workers with long unemployment spells. Thus even in a year of strong economic growth such as 1996, when the economy grew at 7.4 percent a year, 9 percent of the unemployed were without jobs for more than 6 months. This share was above 10 percent for unskilled and older workers (table 4). Rather than extending the duration of UI benefits for all workers—thus accentuating moral hazard problems—it may be more desirable to provide special training programs or other programs targeted to the long-term unemployed. This could improve their probability of reemployment, while preserving job search incentives for the majority of workers.¹¹

Table 4. Unemployment Duration (months)

	(0 – 1)	(1–3)	(3– 6)	(6– 12)	(12+)	>6
All workers,						
national	49.2	33.3	8.6	6.2	2.7	8.9
Female, urban	46.8	35.6	8.3	5.7	3.5	9.3
Male, urban	48.9	33.5	9.1	6.4	2.1	8.5
15–25, urban	47.0	37.1	9.2	5.0	1.7	6.7
25–49	49.0	32.9	8.2	6.8	3.1	10.0
50–65	45.8	32.8	10.2	6.2	4.9	11.2
Unskilled	45.8	32.8	10.2	6.2	4.9	11.2
Skilled	46.9	34.8	8.9	6.4	3.0	9.4

Source: CASEN (1996).

¹¹ A recent review of the effects of training for unemployed workers found that these programs often improve participants' employment prospects (Betcherman, Olivas, and Dar 2004). Yet the effects tended to be more positive in developed and transition economies than in middle- or low- income countries. On-the-job-training was found to be the most promising, while classroom training was found to be less effective.

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Male, urban	48.9	33.5	9.1	6.4	2.1	8.5
15–25, urban	47.0	37.1	9.2	5.0	1.7	6.7
25–49	49.0	32.9	8.2	6.8	3.1	10.0
50–65	45.8	32.8	10.2	6.2	4.9	11.2
Unskilled	45.8	32.8	10.2	6.2	4.9	11.2
Skilled	46.9	34.8	8.9	6.4	3.0	9.4

Source: CASEN (1996).

- *Low returns.* Despite being managed by a consortium of administrators of pension funds, the sole administrator of UI—(AFC)—has attained lower returns for assets under their control than comparable fixed-rent assets managed by pension fund managers (Ramos 2005). Thus it is possible that a sole provider yields lower fees but also lower returns than in the situation where many administrators compete for accounts. Lower returns could also be associated with the small balances in the UI, or with limitations in the choice of instruments relative to the instruments allowed in pension funds. A related concern is that the quality of the services delivered may suffer as a result of the monopolistic position of the sole administrator. While consumers have rated the service highly so far (Ramos 2005), there have been some unnecessary delays in the payments of benefits that need to be corrected (Larrain 2005).
- *Low voluntary affiliation.* Only a small percentage of the total number of affiliates has enrolled voluntarily. It is quite likely that workers with long tenures consider that in the event of unemployment, they will be adequately covered by severance payments. Yet a number of workers with tenures between three and five years are not enrolled, but could increase the resources obtained in case of unemployment if they were. It is important to study why there has been such low voluntary affiliation. In particular, there is a need to determine whether this is a problem of lack of information, myopia, or insufficient valuation of the system.

- *Higher labor costs.* The introduction of the UI system increased labor costs for employers unless wages adjusted downward to compensate for the increase in benefits. Thus before the introduction of UI, and assuming a probability of dismissal of 15 percent, a typical employer expected a cost of 8.33×0.15 per year in severance pay. After the introduction of UI, the cost per worker (as a percentage of the wage) became $(8.33 - 1.6) \times 0.15 + 1.6 + 0.8$. The first term corresponds to the expected payment of the severance pay minus the credit for contributions in the workers' account. The second and third terms correspond to the contributions to a worker's individual account and to the Common Fund, respectively. The increase in costs is equal to $3.41 - 1.25 = 2.16$ percent. To the extent that contributions to the UI, and in particular to the Common Fund, are seen as a tax on labor rather than a deferred payment, an increase in contributions will increase labor costs and have potential adverse effects on employment (Heckman and Pagés 2004). It is therefore important to monitor the effects of such contributions on labor market outcomes.

The above discussion is related to the often stated proposition that, given the documented negative effects of employment protection, it is advisable to continue reducing severance pay while increasing UI contributions. Since firms pay mandatory severance only if workers are laid off, while payments to the UI scheme are noncontingent, such changes will result in an increase in labor costs unless they are converted at a rate given by the probability of dismissal.

- *Higher wage rigidity.* UI, by improving the bargaining power of workers in the face of adverse shocks, may lead to higher equilibrium wages and higher unemployment rates (Blanchard 1999). Cowan and others (2005) find evidence of substantial downward wage rigidity in Chile during the 1999–2002 downturn. Such rigidity could increase with UI insurance, and its effects could be felt in the event of a negative aggregate shock.
- *Possibility of excess accumulation.* High levels of savings are inefficient if the valuation of such savings is much lower than the valuation of the foregone consumption that could be afforded by such savings. The fact that workers are

not voluntarily enrolling in the UI system and that savings have to be forced suggest a high preference for current consumption (Coloma 2000). While the law fixes a maximum period of uninterrupted contributions of 11 years, future evaluations should assess whether workers engage in excessive job mobility to cash out the balances in their accounts. If present, such problems can be reduced by stopping contributions after a certain minimum balance has been reached. An alternative approach, as suggested by Cowan and Micco (2004), is to make contributions decrease with individual account balances.

- *Insufficient insurance in recessions.* While being laid off is stressful and costly, job losses become even costlier in recessions, when job destruction increases relative to job creation and the median duration of unemployment increases. Future evaluations should assess whether the duration of benefits is appropriate in those times. If not, a possible model to imitate is the one followed by the United States, in which the duration of benefits in a state is automatically extended if the unemployment rate in that state is above 10 percent.
- *Low integration between unemployment and old-age pension individual accounts.* The resources accumulated in retirement individual accounts could be put to use to increase the replacement rate during periods of unemployment above and beyond the minimum guaranteed by UI. Yet, given the likely presence of liquidity constraints, it is advisable to impose limits to the free transferability of resources across instruments.
- *Voluntary contributions.* The UI Law did not contemplate the possibility that workers, employers, or both would make voluntary contributions beyond mandatory ones. It is feasible that at least some workers would like to increase their contributions to be better protected in the event of unemployment.

Potential for other Countries

To what extent is the Chilean system a valid model of income support for the unemployed in other middle- and low-income countries? Countries should base their choice of income support mechanisms on their institutional capacity and labor market development.

Countries with low institutional development and a large informal sector should rely less on unemployment insurance and more on other income protection mechanisms such as self-insurance (Vodopivec 2006). Many Latin American countries are not at a stage where they can run an efficient unemployment insurance system, Gill and Ilahi (2000) caution.

Against this backdrop, it is important to emphasize that the Chilean system is a hybrid between traditional insurance and self-insurance mechanisms. By combining different ingredients, it attempts to maximize the gains and minimize the shortcomings of both insurance and self-insurance. This concept of a hybrid model could be attractive for other developing countries. By mixing the basic income protection ingredients (severance pay, unemployment insurance savings accounts, public work programs, and social insurance) in different proportions according to the characteristics of the countries, countries can attain a better income protection system.

Thus, for example, countries with low State capacity but somewhat more developed financial markets could combine self-insurance based on individual saving accounts with some components (programs) that cover unemployed individuals with low individual savings account balances. In lower-income countries, such risk pooling can be attained with public work programs. In countries where targeting is well developed but the informal sector is large, it could be attained with means-tested transfers.

The difference between a means-tested transfer and unemployment insurance benefits is that the transfer is based on [[the beneficiary]] having low earnings and/or wealth, while the unemployment benefit is conditional on the beneficiary not having a job and actively searching for one. Such a difference is not a minor one, since in countries with a large informal sector; many workers who declare themselves to be actively searching for a job may be working for very low pay in the informal sector. Finally, countries with relative well-developed registries, informal sectors that are not very large, and an efficient State, as is the case of Chile, can combine individual savings accounts with unemployment insurance benefits.

CONCLUSION

After many years of discussion and in the context of a complex economic, political, and social environment, Chile started the implementation of an innovative unemployment insurance scheme, which could be suitable to the reality of many developing countries. Its design incorporates cumulated research on optimal UI design, as well as the lessons from the first generation of UI programs found in OECD countries. It also stems from extensive experience in the administration of individual pension saving accounts. The program consists of saving accounts and a redistributive pillar. Such a combination reduces the over-use and abuse problems associated with traditional UI and thus improves the focus and efficiency of the overall system.

Another important innovation has to do with the administration of the individual accounts and Common Fund. Economies of scale and low elasticity of demand conspire against competition. This, combined with the low balances in the accounts, would have resulted in impossibly high administration fees. To solve this problem, the system auctions the market to a single fund administrator for 10 years. To reduce costs further, services such as account management and information and payment offices are subcontracted to specialized providers.

The short time of implementation and the lack of pre-established control and treatment groups reduce the scope for evaluation of the program. Thus it is yet too early to assess whether the Chilean UI will deliver on its promises in a cost-effective manner over time. Efforts should be made to assess the performance of the program against clearly established counterfactuals. This implies for instance, evaluating how much better UI recipients can smooth consumption and diversify risk relative to *comparable* workers who do not receive UI. These evaluations should precede any changes in the system. The lessons learned will also be very valuable for ongoing efforts by other countries to design suitable income protection mechanisms for unemployed workers.

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Summary Findings

This paper describes the Chilean experience concerning the implementation of a new unemployment insurance (UI) program. The use of individual savings accounts and private management are essential elements. In addition, a redistributive fund (Common Fund) helps workers pool risks, distributing resources from employed to unemployed workers and from stable firms to workers with low incomes and unstable jobs. The combination of personal accounts and redistribution reduces moral hazard problems endemic to traditional UI schemes and keeps costs at manageable levels. The paper discusses the political, social, and economic context in which this program was enacted and implemented, it reviews its key characteristics, it assesses the initial performance of the system in terms of coverage and benefits and it assesses the challenges that lie ahead. Finally the paper discusses the potential of this system as a model for other middle- and low-income countries

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