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# **Labor Markets and Income Support: What Did We Learn From the Crises?**

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### **Abstract\***

The adoption of emergency employment and short term training programs to provide income support to the population affected by the episodes of economic volatility since 1995 reveals the failure of the traditional, labor law-based income support mechanisms in the region. These emergency programs are not additional and transitory, but rather have become a permanent component of social policies. As such, they present policymakers with the opportunity to build a more encompassing and better designed mechanism to protect workers against the effects of macroeconomic volatility. The paper argues for an income support system centered on unemployment insurance, complemented with additional mechanisms to provide effective income support to workers during normal times; the paper also discusses what changes are necessary in emergency programs to make them work as part of that system.

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## Introduction

The high level of macroeconomic volatility that has historically affected Latin American economies has not diminished with the adoption of growth-oriented sustainable economic policies. Economy-wide shocks like the Tequila effect in 1995 and renewed instability since 1997 have induced governments to revisit the idea of creating mechanisms that could protect the population from income losses.

Structural reform and macroeconomic stabilization have increased the risks that workers face given the vulnerability of domestic production to changes in international capital and goods markets. At the same time, the traditional legally mandated severance payment mechanisms established in the labor laws have become irrelevant in this new environment, given the narrow scope of their coverage.

Therefore, countries in the region did not have the option of expanding “normal” income support programs when hit by economy-wide shocks, but had to adopt emergency responses. The programs that resulted from these responses constitute more a mosaic of often unrelated initiatives than a coherent and well thought out system of income support. However, the fact that these emergency programs are in place creates an opportunity to build a more permanent system of income support that rectifies traditional mechanisms’ shortcomings.

The question this paper attempts to address is how a more comprehensive income support system can be built starting with those emergency programs. In other words, what is required to transform this mosaic of programs into a coherent set of mechanisms that can provide income support to workers both in an economy-wide shock, and in the normal process of job churning that flexible and dynamic labor markets experience? Efforts to cope with economy-wide shocks are doomed to failure if we do not count on mechanisms that can provide income support in the normal course of business, and that can expand to help workers cope with economic downturns.

The paper does not attempt to extrapolate from this small and haphazard set of programs a complete social risk management framework. Not only would such extrapolation be unwarranted, given the limited size and scope of the programs in place, but also social risk management must also by necessity include programs that do not operate through the labor market (such as subsidies for school attendance by school-age children, social investment funds, and demand side subsidies to health service consumption, to mention just a few).

What the paper does attempt is to draw some conceptual generality from the practical (and very real) particularities of the implementation of labor market based income support devices in the region. By doing so, it can help policy makers to put emergency measures in the broader and more structured framework of the long term objective of helping workers cope with both economy-wide and idiosyncratic shocks that result in income losses and unemployment.

In the first section, we will discuss how the traditional legally mandated severance payment system fails to work both because it covers a dwindling fraction of the population and because it creates rigidities that hinder the ability of firms to operate in more open and contested markets. The second section will be dedicated to a characterization of the labor market-related income transfer programs that seven countries in the region had in place around 1995, and that were used to attempt to mitigate the impact of the Tequila crisis on their labor markets. There we will argue that these emergency programs were not designed in such a way as to act as counter-cyclical devices, and in some cases created important labor market distortions. The third section

will present a discussion of the changes needed in each of these programs to mitigate the negative externalities they generate, and to enhance the positive ones. Finally, in the fourth section we will present some ideas on how to develop from these emergency programs an income protection system centered on a well-designed unemployment insurance system, complemented by employment generation and short-term training programs to address the needs of workers who do not have access to unemployment insurance.

## **The Failure of Traditional Income Support Mechanisms in Latin America**

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

The “social justice” rationale behind these employment security regulations is quite well known. Firms enjoy rents that arise from high tariffs and other forms of privileged access to financial and non-financial resources in the context of so-called “crony capitalism,” and employment security is just one form of sharing those rents with their employees. In a sense, the system works as privately implemented unemployment insurance with coverage limited to those workers in a regulated employment contract. These workers are protected both because the firm has a positive cost associated with termination (that ensures that layoffs and firings will be used sparingly as adjustment mechanisms), and because workers who become unemployed receive an income transfer through the payment of severance.

This pattern of employment security that protects the job but not the worker after losing his or her job is associated with the “polarized” model of wage setting (Banuri and Amadeo, 1992). For the purpose of protecting against income volatility, this model of regulation provides effective protection against income losses to a minority of highly organized and vocal workers, while leaving a large fraction of the working population uncovered either in non-regulated employment contracts or in self-employment.

In the cozy environment of a semi-closed economy this was possible because demand-boosting government policies, however unsustainable, protected the domestic market against external shocks. Workers who lost their jobs received severance payments and could find or invent an alternative job in the unregulated sector of the economy. In an inflationary environment real wages could be adjusted by raising nominal wages more slowly than the general price level. Therefore, employment in the regulated sector was quite stable, unemployment was low, and the adjustment variable in the labor market was the real wage.

To the extent that demand-boosting government policies deepened the misallocation of resources resulting from protectionism and cronyism, the growth performance of the region deteriorated during the eighties. As a consequence, employment in the regulated sector remained stagnant and employment in non-regulated jobs without any form of protection against income loss grew to cover almost half of the working population (see Márquez, 1997). Therefore,

protection against income volatility ended up covering just the fraction of the labor force employed in the bigger and more closely regulated firms.

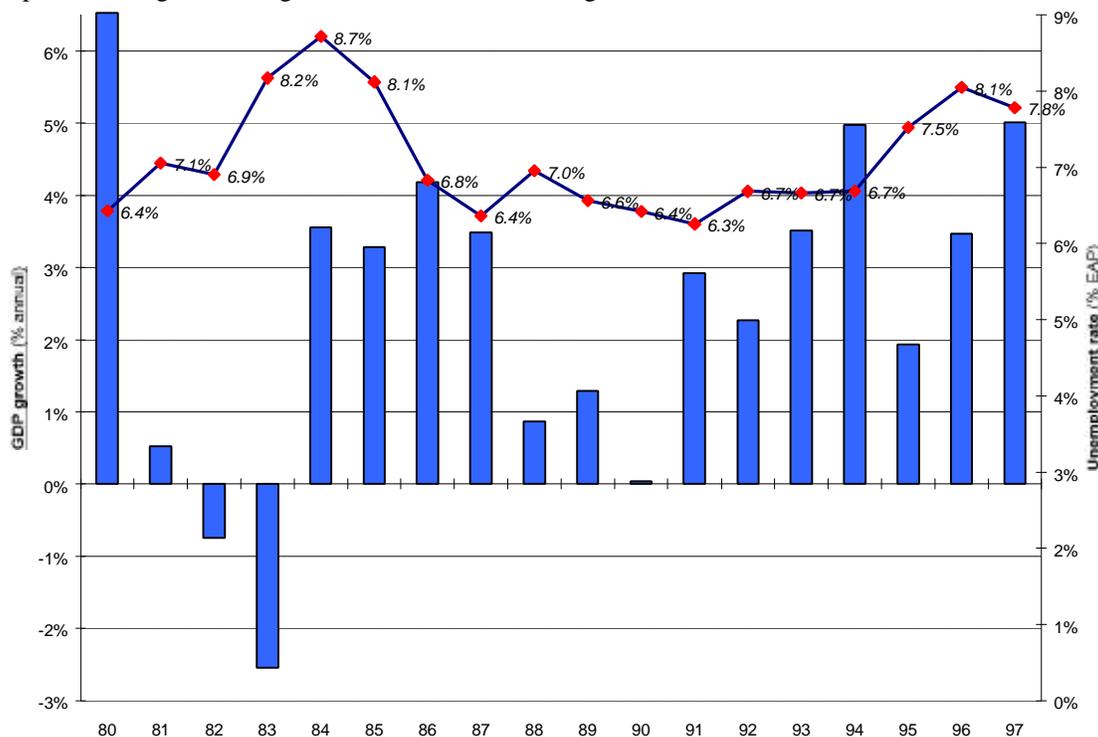
In the more dynamic environment that resulted from economic opening and stabilization at the beginning of the 1990s, the relevance of this model of protection is questioned by the increase in the pro-cyclicality and level of unemployment. What caused these changes in unemployment? First and foremost, structural reforms and macro stabilization changed the relative prices of capital and labor in favor of the former (Lora and Olivera, 1998). This in and of itself increased the use of physical capital and slowed employment generation. But macro stabilization also implied important changes in the employment behavior of the public and private sectors.

Public sector retrenchment resulted in the displacement of workers, which increased the stock of unemployed. More importantly and of larger consequences, the maintenance of low or zero fiscal deficits required by fiscal discipline made it impossible for governments to act as employers of last resort, as they had done directly or indirectly in the crisis of the eighties (Lora and Márquez, 1998).

The reduction of inflation reduced the latitude that private (and public) employers had enjoyed to reduce real wages through nominal wages lagging behind inflation. The increased nominal rigidity makes employment—and not real wages—the adjusting variable in the labor market during economic downturns. Therefore, shocks translate into higher unemployment rather than a collapse of real wages (Márquez and Pagés, 1998). Once this higher level of unemployment is reached, slower employment generation makes unemployment reduction a more protracted and prolonged process over time (Márquez, 1998).

**Graph 1: Unemployment and Growth in Latin America, 1980-1996**

(Population-weighted averages for 17 countries in the region)



Source: Growth of GDP at constant 1990 US\$ from IADB Statistical data base; unemployment data from ILO *Panorama Laboral*.

From a world where unemployment was almost absent, and where low-quality jobs in the non-regulated sector were the crux of the problem, we jumped into a brave new world of growing unemployment. By the end of 1998 a record number of countries in the region were experiencing double-digit unemployment rates (Argentina, Colombia, and Venezuela being the most notorious cases) and, more troubling, unemployment remains high when the economy recuperates after each shock (see Graph 1). Although macro and financial policies are used to limit domestic vulnerability to external shocks, the fact remains that the recessionary environment of 1999 is translating in most countries into more unemployment and falling wages, particularly for less skilled workers.

But perhaps the most damaging blow to the relevance of severance payments-based income protection has been the recognition that privately insuring workers against income losses may hurt the ability of firms and workers to profit from the enhanced opportunities associated with a more open and competitive economic environment. Colombia in 1990, Peru in 1991, Nicaragua and Argentina<sup>1</sup> in 1995, and Venezuela in 1997 have enacted reforms of labor regulations aimed at creating more flexible forms of employment contracts, both through the reduction of firing costs and through the introduction of promotional contracts with lower payroll taxes.

One of the impacts of these reforms has been a further reduction in the share of full-benefit contracts in total employment, with a corresponding expansion of more precarious forms of employment. The introduction of more flexible forms of employment contracts has not in fact weakened the employment protection enjoyed by workers in the old full-benefit, full-protection employment contracts. With relatively few exceptions, the labor reforms enacted during the 1990s have aimed at flexibilizing hiring and firing conditions at the margin, without diminishing the legal protections enjoyed by workers already employed. Making the changes binding only on new labor contracts has in fact grandfathered employees already on the job. However, as the new contractual forms have cost advantages for firms, employers have substituted workers in full-benefit contracts by workers under the more flexible contracts. In Argentina, for instance, promotional employment contracts generate lower payroll taxes and do not generate rights to severance payment upon termination. According to official data<sup>2</sup> the number of new jobs created under promotional contracts more than doubles the number of new full-benefit contracts, while the opposite is true regarding the number of workers terminated under each type of contract.

In summary, as of the mid-1990s we found ourselves in a situation where unemployment was higher and more sensitive to economic downturns, and where more than half of the employed did not have any protection against the risk of income loss associated with unemployment. Economic downturns may thus result in very large income losses for both the unemployed and workers in more precarious employment contracts, and society does not offer them any formal mechanism to insure against that risk.

## **The “Emergency” Income Support Mechanisms of 1995**

In order to at least partially compensate for the adverse labor market effects of the Tequila effect in 1995, governments in the region adopted and/or expanded labor market policies and programs aimed at supporting incomes and/or expanding employment opportunities for particularly vulnerable groups. The renewed volatility in international capital markets since the end of 1997

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<sup>1</sup> Some of the Argentina reform measures of 1995, however, were partially reversed in 1998.

<sup>2</sup> *Encuesta de Indicadores Laborales*, Min. de Trabajo y Seguridad Social, October 1998.

has maintained the interest of policymakers in the adoption of income support programs and suggests that these programs are more permanent than what the “emergency” label indicates.

The enactment of these programs has created an opportunity to test some new ideas and to disseminate innovative approaches to old problems. Labor-intensive public work programs, youth-targeted training programs, and semi-universalized unemployment insurance systems all became acceptable ideas to help sustain the fragile political coalitions behind the economic modernization process.

These programs were designed in a crisis context, when incomes were falling, unemployment was increasing, and the risk of losing political support for the reform efforts was high. Therefore, the ability of these mechanisms to expand and reach the groups at risk as fast as possible took priority over optimal design considerations. As a consequence, we ended up with a mosaic of programs and mechanisms that lack the coherence and size necessary to fulfill the role of income support for wider groups of the population. In addition, these measures often introduce labor market distortions and have difficulties adjusting counter-cyclically.

On the positive side, these programs are generally well suited to the institutional layout of the countries and have demonstrated capability to deliver resources fast. The experience of the region with income support programs shows that they can, at least to some extent, help to compensate for the effects of economy-wide shocks on workers. A varied array of programs has been used to help workers cope with one or another of the damaging effects of economy-wide shocks. This battery of programs will be the backbone of any income support system, given organizational, political, and resource constraints that limit the ability of the government to create new programs.

Given the urgency of coping with the effects of the crisis, the quest for mechanisms that could be set up quickly to transfer income to the poor in the most targeted way possible dominated any optimal design consideration. In a perfect world, countries would have automatic mechanisms as unemployment insurance to protect vulnerable groups during economic shocks. In reality, however, few countries in the region have a system of unemployment insurance and, even in those countries, the protection of unemployment insurance is limited to a relatively small fraction of the total workforce.

What the countries did was to put in place or expand a wide array of actions, programs, and policies that were considered suitable as income transfer devices and that could be expanded on short notice. Labor-intensive public works programs executed in a decentralized fashion by sub-national governments or non-governmental (NGOs) organizations were widely used. Short-term training program with scholarships and some form of job search assistance were also used to provide an immediate source of income for the beneficiaries.

Public investment programs were not used as employment programs, in spite of their important direct and indirect employment effects. Part of the reason for this was the lack of fiscal resources to finance their execution; it was often the case that investment programs were used as an adjustment variable in equilibrating the fiscal budget. Besides, there is no technical reason why

(and often many why not) a large-scale investment in sanitation, for instance, should be executed with labor-intensive technology.<sup>3</sup>

The particular responses of different countries varied widely both in function of tradition and history of labor market programs implementation, and in terms of the political equation that made diverse groups more or less visible as objects of income protection. Generally speaking, governments reacted along two main lines. Where organizational and political constraints permitted, labor intensive public work programs were implemented. Where the perception was that youth unemployment was a particularly important problem, training programs that targeted unemployed youth as clientele were implemented. Some governments in the region opted for developing both lines of action simultaneously, while some others opted for an ever-wider variety of programs that also covered subsidization of private sector employment generation.

### **Unemployment Insurance**

In Table 1 we present a summary description of unemployment insurance systems in the region. As can be seen, very few countries in the region have legally and/or administratively enacted unemployment insurance systems, and even fewer have working unemployment insurance schemes. This is a consequence of the very weak incentives that exist for the development of unemployment insurance and other more socialized forms of income protection, given the fact that severance payments work as privately provided income insurance for workers in full-benefit employment contracts who are laid off.

In those countries that do have unemployment insurance systems, coverage is limited to workers who have contributed while employed to the financing of the system. In other words, only workers in full-benefit employment contracts and working in payroll tax-paying firms enjoy the benefits of the unemployment insurance system. The level of benefits provided and their duration is low relative to more developed countries' unemployment insurance systems. Replacement rates are normally in the order of 50-60% of the last wage, with caps linked to the minimum wage for higher salaries. Benefits are granted for periods typically not longer than four months.

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<sup>3</sup> Another factor that probably explains this is that the redesign of investment programs to incorporate labor-intensive technology takes a long time and requires a complete re-engineering of the investment project, not to speak of the needed institutional redeployment.

**Table 1: Unemployment Insurance in the Region**

|                  | Law                  | Funding                                    | Replacement rates (a)                                   | Benefit duration             | Benefits Min/Max           | Coverage Requirements                             |
|------------------|----------------------|--|---|------------------------------|----------------------------|---|
| <b>Argentina</b> | 1991 reform. 95      | Worker: 1 % wage<br>Empr.: 1.5 % payroll   | 60 %  | 4-12 meses                   | Min: 1 m.w.<br>Max:4 m.w.  | Employees 1 (12), 2,3                             |
| <b>Barbados</b>  | 1982                 | Worker: 1.5 % wage<br>Empr.: 1.5 % payroll | 60 % 10 weeks<br>40% 16 weeks                           | 26 weeks in a 52 week period |                            | Employees 1(6)<br>16-64 yo                        |
| <b>Brazil</b>    | 1986<br>1990         | FAT (.65% tax on total sales)              | 1-3 minimum wages                                       | 4 months                     | Min: 1 m.w.                | Employees 4(36, 4), 5,6                           |
| <b>Chile</b>     | 1981                 | Government                                 | 37\$ monthly for the first 6 months, 18\$ last 6 months | Max. 1 year (b)              |                            | Employees 2, 4(12,2), 5,                          |
| <b>Ecuador</b>   | 1958,<br>1988        | Worker: 2% sal.<br>Empr.: 1 % payroll      | One time subsidy, amounts decided each year.            |                              |                            | Employees 1(24), 7(30)                            |
| <b>Mexico</b>    |                      | Social Security                            | 95 % pension  | 5 years max                  |                            | Employees Between 60-65 yo 65 yo                  |
| <b>Uruguay</b>   | 1981                 | Contributions to Social Security           | Up to 50%   | 6 months                     | Min:0.5m.w.<br>Max: 4 m.w. | Employees 1(6), 5, 3, 8. in commerce and industry |
| <b>Venezuela</b> | 1989 reform.<br>1998 | Worker: .7 % wages<br>Empr.: 1.5 % payroll | Up to 60%   | 13-26 weeks                  | Max. \$44                  | Employees 1(12), 2                                |

Taken from Lora E. and C. Pagés, 1997

Source: S.S. Programs throughout the World – 1995, US Dept. of Health and Human Services

Notes:

a. % last wage.

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

Requirements:

1 (s) – Be employed s months before receiving subsidy.

2 – Availability to work

3 – Does not receive other social security benefits.

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

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

6 – Subject to economic need.

7(x) – Waiting period of x days.

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

The unemployment insurance system in Argentina is quite limited in number of beneficiaries and has remained so in spite of strong increases in the number of unemployed workers. Mazza (2000) reports that the number of beneficiaries has remained stable at between 100 and 125 thousand workers, more than 70% of whom are prime age males, and more than 50% of whom are not household heads. She also reports that an analysis of beneficiaries in their personal and previous job characteristics shows that there is a definite trend towards serving younger and middle class displaced workers. This suggests that unemployment insurance is not fulfilling a safety net role for the poor in the case of Argentina.

Brazil has the largest unemployment insurance system in the region, with between 300-400 thousand beneficiaries. Mazza (2000) reports that unemployment insurance in Brazil is also

serving younger (more than 50% of beneficiaries are younger than 30) and more educated (45% of beneficiaries have completed eighth grade or higher) workers. As IPEA (1998) assesses, the unemployment insurance system reflects wage inequality in that benefits accrue to the middle deciles in the distribution of income.

In Venezuela, the unemployment insurance system was enacted in law in 1989, but it has never been implemented. The system was, however, reformed in 1999. The new system will protect beneficiaries through a mix of individual and collective insurance operated by competitive insurance providers, but implementation has not yet begun as of this date. Given that only workers with regulated, tax-paying contracts are entitled to benefits, it is likely that the pattern of distribution of beneficiaries will be very similar to that of Argentina and Brazil discussed above.

Mexico and Uruguay have unemployment insurance programs operated by the social security system. In both cases coverage is quite limited, and in the former it is just an advance payment of old age pensions for a maximum period of five years. In the case of Barbados case, the unemployment insurance system is very small in coverage, though quite well adapted to the needs of an island economy with frequent but short episodes of unemployment concentrated in workers in the tourism industry (Mazza, 2000).

## Employment Generation Programs

In Table 2 we present a summary description of the employment generation that seven countries in the region had in operation at the end of 1995. The list was extracted from a joint ILO-IADB volume on active labor market policies in Argentina, Brazil, Chile, Costa Rica, Jamaica, Mexico, and Peru. These countries represent a wide spectrum of variation in terms of policy development, operational capabilities, and exposure to international capital markets volatility. Program description and characteristics were summarized in Verdera (1998) and a more thorough discussion of programs is presented in the national reports contained in that volume. An itemized description of the programs is presented in Table A-1 in the Appendix.

**Table 2: Employment Generation Programs in Seven Countries in the Region**

|                   | Beneficiaries |                        | Expenditure  |              |
|-------------------|---------------|------------------------|--------------|--------------|
|                   | 1,000s        | % of total labor force | million US\$ | % GDP        |
| <b>Argentina</b>  | 892.2         | <b>9.31%</b>           | 249.2        | <b>0.09%</b> |
| <b>Brazil</b>     | 221.8         | <b>0.49%</b>           | 1,188.8      | <b>0.21%</b> |
| <b>Chile</b>      | 4.3           | <b>0.10%</b>           | 1.4          | <b>0.00%</b> |
| <b>Costa Rica</b> | 8.1           | <b>0.71%</b>           | 3.3          | <b>0.04%</b> |
| <b>Jamaica</b>    | 6.0           | <b>0.61%</b>           | 21.2         | <b>0.50%</b> |
| <b>Mexico</b>     | 1,024.0       | <b>4.42%</b>           | 1,802.0      | <b>0.51%</b> |
| <b>Peru</b>       | 27.8          | <b>0.93%</b>           | 100.0        | <b>0.19%</b> |

Source: Data from Verdera 1998, modified by the author. For a complete listing, see Table in Appendix.

Argentina is the country with the most varied set of employment generation programs, comprising a combination of public works and subsidies to private employment. Public subsidies to private sector employment, in the form of subsidies to firms that increase the number of employees, were widely used under a variety of mechanisms. Workers displaced from the public sector and unemployed workers receiving unemployment insurance were given vouchers that employers could use to pay tax liabilities. Firms could opt for tax rebates if hiring particular groups of workers (young, women, ex-combatants, etc.) under promotional contractual forms. Also, firms in particular activities (like reforestation) were subsidized if they hired new workers. But the most visible mechanism of subsidization was the use of “promotional employment contracts” established in a series of decrees in 1995. These promoted contracts were more precarious than regular full-benefit contracts, did not originate rights to severance payments, and produced lower payroll tax liabilities.

Argentina’s federal government also financed labor-intensive public works as an employment generation device. The *Trabajar* and similar programs were financed and supervised by the federal government using the *Fondo Nacional de Empleo* (a fund financed through payroll taxes). The resources were used to build small scale and labor-intensive public works (in many cases social infrastructure, but also roads and small sanitation works), with the works being executed by a wide variety of agencies, ranging from local and state governments to NGOs.

The *PROGER* program in Brazil is a contrasting mechanism for employment generation. The program operates through the establishment of credit lines offered through the national development banking system to small enterprises, cooperatives, NGOs, and other civil society associations. This mechanism serves to circumvent the sub-national governments for works execution in order to avoid the creation of budgetary entitlements. Partial and incomplete evaluations of *PROGER*, however, are not very optimistic about the results in terms of employment generation.<sup>4</sup>

Chile does not have any employment generation program as such, though it has a number of very small and narrowly targeted programs to address living conditions that may hinder the labor market insertion of particular groups.

Costa Rica uses public works, wage subsidies, and credit to small enterprises as mechanisms to promote employment generation. Credit to promote employment generation in small firms is also widely used in Jamaica in a battery of programs, some of which also include a form of short-term training. Jamaica additionally has a training and temporary employment program for unemployed youth, aimed at easing their labor market insertion.

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

Finally, Peru uses legal incentives, a social investment fund, and a micro and small enterprise credit program as tools for employment promotion. The labor law reform of 1991 introduced a number of more precarious forms of employment contracts, allowing firms to hire workers without generating rights to severance payments under fixed term contracts.

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<sup>4</sup> *Relatorio da forca-tarefa sobre políticas de emprego – Diagnóstico e recomendaciones*, Min. do Trabalho, Brasília, Agosto 1998.

FONCODES, a social investment fund, is also used as an employment generation device that can be quickly adjusted to the situation of local labor markets. However, it is not clear how much capacity or interest FONCODES management has in employment generation as opposed to the physical execution of civil works (Verdera 1995).

### **Training as Income Transfer Program**

In Table 3 we present a summary description of the training programs that were being used as income transfer devices in seven countries in the region by the end of 1995 (Verdera,1998). An itemized description of these programs is presented in Table A-2 in the Appendix. Training programs were widely used as a mechanism to transfer income, particularly to unemployed youth, through scholarships during the classroom-training period (normally three to six months) and in some cases through job search assistance and/or apprenticeship stages in private firms. In most cases these training programs were financed by the government and delivered by private and NGO training providers, with little or no intervention of the traditional National Training Institutions

The basic operational technology of these training programs was based on *Chile Joven*, a pioneering youth training program that combined a scholarship for classroom training with a three month paid apprenticeship in a private firm. Instead of direct purchasing of training services, resources are used to create a fund that is managed by a central government agency. The managing agency requests proposals for training projects, and funds are granted through open bidding. The proposals must describe the content of the courses to be taught and must include a commitment from private sector firms to accept the trainees as apprentices for a period of time (normally three months). The provision of scholarships served as an income transfer to beneficiaries, took them out of the unemployment queue, and gave them some labor market experience during the apprenticeship. These three beneficial effects of the *Joven* program were quite adequately suited to situations characterized by high youth unemployment rates.<sup>5</sup> However, other countries in the region emulated the contracting methodology of the *Joven* program to cater to the needs of other population groups.

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<sup>5</sup> The contracting mechanism of *Chile Joven* was in fact a way to create incentives for training providers to deliver good quality and labor market-relevant content of their courses. This created pressures for an institutional and content revamping of the training system, as firms accepting apprentices acted as controllers and gatekeepers of the relevance and adequacy of the training provided. The program was therefore rightly perceived as a tool to modernize and connect the training system with real productive activities.

**Table 3: Training Programs in Seven Countries in the Region**

|                   | Beneficiaries |                        | Expenditure  |              |
|-------------------|---------------|------------------------|--------------|--------------|
|                   | 1.000s        | % of total labor force | million US\$ | % GDP        |
| <b>Argentina</b>  | 133.0         | <b>1.4%</b>            | 95.6         | <b>0.04%</b> |
| <b>Brazil</b>     | 740.5         | <b>1.6%</b>            | 310.2        | <b>0.06%</b> |
| <b>Chile</b>      | 36.6          | <b>0.8%</b>            | 18.3         | <b>0.03%</b> |
| <b>Costa Rica</b> | 13.1          | <b>1.2%</b>            | 60.6         | <b>0.73%</b> |
| <b>Jamaica</b>    | 43.5          | <b>4.4%</b>            | 18.6         | <b>0.44%</b> |
| <b>Mexico</b>     | 410.3         | <b>1.8%</b>            | 135          | <b>0.04%</b> |
| <b>Peru</b>       | 1.5           | <b>0.1%</b>            | 5.0          | <b>.01%</b>  |

Source: data from Verdera 1998, modified by the author. For a complete listing, see Table in Appendix.

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

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

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

Jamaica uses a number of programs to provide training for unskilled and young unemployed workers, but the mechanism for income transfer is temporary jobs rather than scholarships during training.

Mexico has the largest training with income transfer program in the region, and it has been effectively used as a protective device for unemployed and displaced workers, expanding and contracting according to the economic cycle. The PROBECAT program provides a scholarship for the beneficiaries, and the state offices of the Labor Ministry organize a variety of training programs that are delivered locally. Different program evaluations have found that the program has been somewhat successful as a training program, increasing incomes and likelihood of employment for beneficiaries, even though positive effects tend to increase with higher levels of education among beneficiaries.<sup>6</sup>

## Expenditure on Income Support Devices

In general terms, the seven countries in our sample invest a smaller fraction of GDP in unemployment insurance, employment generation, and training-cum-income-transfer programs than a wide sample of more developed OECD countries (Table 4). On average, the countries in our sample spend less than half a point of GDP in these programs, while the average for the OECD countries is 2.4% of GDP. Only the US, Japan, and Greece spend a smaller fraction of GDP on these programs than the LAC average.

Mexico is the country that spends the most resources in employment generation (one half of a percentage point of GDP) to benefit around 4% of the total workforce, while Argentina reports expenditure below one tenth of 1% of GDP to benefit around 9% of the total workforce. Resources invested in training programs<sup>7</sup> are of the same order of magnitude as those dedicated to employment generation programs, though the number of beneficiaries seems to be somewhat bigger.

It is also interesting to note that countries in the region that do have unemployment insurance systems (Brazil and Argentina) spend less on unemployment compensation than even the less spendthrift countries in the OECD.

**Table 4: Expenditure on Labor Market Programs, OECD and Latin American Countries** (% of GDP)

|                       | Training for<br>unemployed | Employment<br>generation | Unemployment<br>compensation | Total |
|-----------------------|----------------------------|--------------------------|------------------------------|-------|
| <b>OECD countries</b> |                            |                          |                              |       |
| Australia (1994-95)   | 0.23                       | 0.21                     | 1.62                         | 2.06  |
| Austria (1995)        | 0.13                       | 0.05                     | 1.30                         | 1.48  |
| Belgium (1995)        | 0.24                       | 0.68                     | 2.11                         | 3.03  |
| Canada(1994-95)       | 0.29                       | 0.07                     | 1.50                         | 1.86  |
| Denmark (1995)        | 0.86                       | 0.36                     | 3.06                         | 4.28  |
| Finland (1995)        | 0.60                       | 0.68                     | 3.57                         | 4.85  |
| France (1995)         | 0.67                       | 0.40                     | 1.43                         | 2.50  |
| Germany (1995)        | 0.44                       | 0.44                     | 2.08                         | 2.96  |
| Greece (1995)         | 0.04                       | 0.09                     | 0.44                         | 0.57  |
| Italy (195)           | 0.39                       | 0.69                     | 0.68                         | 1.76  |
| Japan (1994-95)       | 0.03                       | 0.06                     | 0.39                         | 0.48  |
| New Zealand (1994-95) | 0.44                       | 0.15                     | 1.26                         | 1.85  |

<sup>6</sup> *Capacitación y Empleo: Evaluación del programa de becas de capacitación para desempleados*, Sec. De Trabajo y Previsión Social, Mexico DF, Agosto 1995

<sup>7</sup> These figures exclude the expenditure of the traditional National Training institutions.

|                      | <b>Training for unemployed</b> | <b>Employment generation</b> | <b>Unemployment compensation</b> | <b>Total</b> |
|----------------------|--------------------------------|------------------------------|----------------------------------|--------------|
| Spain (1995)         | 0.33                           | 0.31                         | 2.46                             | 3.10         |
| Sweden (1994-95)     | 0.98                           | 0.90                         | 2.51                             | 4.39         |
| US (1994-95)         | 0.07                           | 0.01                         | 0.35                             | 0.43         |
| <b>LAC countries</b> |                                |                              |                                  |              |
| Argentina (1995)     | 0.04                           | 0.09                         | 0.14                             | 0.27         |
| Brazil (1995)        | 0.06                           | 0.21                         | 0.19                             | 0.46         |
| Chile (1995)         | 0.03                           | -                            | -                                | 0.03         |
| Costa Rica (1995)    | 0.73                           | 0.04                         | -                                | 0.77         |
| Jamaica (1995)       | 0.44                           | 0.50                         | -                                | 0.94         |
| Mexico (1995)        | 0.04                           | 0.51                         | n.a.                             | 0.55         |
| Peru (1995)          | 0.01                           | 0.19                         | -                                | 0.20         |

Notes: Training for unemployed includes training for the unemployed adults and those at risk, plus measures for unemployed and disadvantages youth and support of apprenticeship programs.

Employment generation includes all forms of subsidized employment, plus direct job creation by public and non-profit sector.

Unemployment insurance includes all expenditure on benefits, independently of source of financing.

Source: For OECD countries, Table J, ps. 211-218, *Employment Outlook*, June 1998, OECD.  
For LAC countries, Verdera(1998).

These comparative figures suggest that there is room for expansion of the expenditure in income support programs. Even doubling the expenditure on these programs (an increase well beyond any reasonable expectation) would not make countries in the region big spenders in international terms.

## **The Pieces of an Income Support System**

The repeated bursts of economic instability during the 1990s induced governments to revisit the idea of creating mechanisms that could protect the population from income losses. These efforts, described in the previous section, were conceived as emergency measures aimed at transferring resources as fast as possible to vulnerable groups of the population affected by an economy-wide shock. Much more attention was paid to the capacity of these programs to expand rapidly than to their ability to expand or shrink in response to demand. This trait made these programs a semi-permanent component of social sector expenditures, therefore raising all types of questions regarding their role in a comprehensive social policy.

One question that has been overlooked in the discussion about income support programs is what they tell us about the failure of the established mechanisms in our societies to protect workers (including the poor) from the effects of both economy-wide *and* idiosyncratic shocks. Because of the failure of the traditional income support mechanisms (i.e., the severance payment system) there is an absence of mechanisms to deal with the income losses associated with the idiosyncratic shocks normal in the process of job churning. Therefore, when hit by the crisis countries in the region did not have the option of expanding “normal” income support programs, but had to adopt emergency responses. On the positive side, however, these emergency programs create the opportunity to build a more permanent system of income support that rectifies the traditional mechanisms’ shortcomings.

This system of income support should operate through the labor market, because labor is the only asset for an overwhelming majority of the population and because most of the transmission mechanisms of shocks operate through labor demand (Lustig and Walton, 1998). Programs and policies that facilitate the use of labor in income earning activities will be the most

effective to mitigate the impact of cyclical or shock-originated downturns on workers. However, when workers fall into unemployment their consumption capacity needs to be protected (be it by generating employment, or by providing other forms of income support) without generating a dependency trap.

From a design point of view, these mechanisms should provide a minimum income guarantee to all workers. To be feasible in financial and economic terms, they need to fulfill at least three requirements:

- Their design should not introduce labor market distortions and, in particular, should not induce workers to reduce their search effort or increase their reservation wages.
- Their coverage should be as wide as possible, given that the risk of unemployment affects all workers, including those in non-regulated and precarious forms of employment contracts.
- Their budget allocation should be adjusted counter-cyclically, expanding in economic downturns when unemployment increases, and contracting in expansions when it decreases.

How well do the programs and mechanisms already in place in the region comply with these requisites? Table 5 presents an attempt to summarize some characteristics of these programs relative to those criteria. In the most general possible terms we find that an effective and relevant income protection system should be a composite of programs offering different mechanisms targeting different groups as a function of their human capital levels and labor market insertion.

**Table 5: Some Criteria for Evaluation of Income Protection Programs in the Region**

| <b>Program</b>   | <b>Labor market distortions</b>  | <b>Coverage</b>   | <b>Counter-cyclicality</b>  |
|--|--|---|---|
| <b>Cash transfers</b>  | Very important<br>Reduce incentives for labor market participation   | Requires very thorough and expensive targeting system to target the poorest.  | Low<br>Create entitlements, contraction is politically very expensive.  |
| <b>Unemployment insurance</b>  | Low if well designed (individual contributions, low replacement rates, short period of benefits)   | High productivity workers in regulated employment contracts.<br>Requires keeping of administrative records  | High, automatic   |
| <b>Employment generation programs</b>  |  |   |   |
| <ul style="list-style-type: none"> <li>• Labor intensive public works</li> <li>• Wage subsidies</li> </ul> | <p>Low if well designed (wages below average wages of poor deciles)</p> <p>High<br/>Induce substitution of non-subsidized by subsidized groups</p> | <p>Local labor markets<br/>Self-selection into the program</p> <p>Narrowly defined groups<br/>Requires supervision capacity and keeping of administrative records</p> | <p>Politically expensive if the program generates budgetary entitlements of sub-national governments</p> <p>Potentially very high, though program may create entitlements</p> |
| <b>Scholarships for short-term classroom training, apprenticeships, and job search assistance</b>          | Low<br>May increase participation rates of target group<br>Increase the efficiency of market exchange mechanisms                                   | Targeting is easy on observable characteristics, self-selection<br>More adequate for unemployed youth and new-entrants, not very useful for displaced workers         | High.<br>Requires maintenance of the network of non-government providers.   |

## Cash Transfers

The most immediate and direct way to protect unemployed workers' income is through cash transfers to families that fall below a predetermined income level. Even though the criteria for receiving benefits from the program is formulated in terms per capita family income, low family income levels are associated with either very low wages (Hausmann and Székely, 1998) or unemployment.

Cash transfer programs usually target the poorest segments of the population, who cannot obtain a minimum survival income level in the labor market. In many cases, a cash transfer is part of a more comprehensive program aimed at protecting and furthering the ability of low income families to maintain and accumulate human capital and, therefore, to “graduate” from the program.<sup>8</sup> Because these families are poor to begin with, economy wide or even idiosyncratic shocks can put into question their ability to sustain minimum consumption levels. Therefore, a cash transfer can help them smooth their consumption levels.

However, cash transfers induce very important labor market distortions, by increasing reservation wages and creating incentives against work. Because they do not require any counterpart work effort (making participation in the program effectively a free good), these programs also require a very sophisticated targeting system and a complex system of verification and enforcement, to avoid fraud by inclusion of non-needy families and to avoid exclusion of needy ones. Cash transfers also tend to create strong entitlements among the beneficiaries, making it extremely hard to adjust either the number of beneficiaries or the amount of benefits in a counter-cyclical fashion.

## Unemployment Insurance

Though differences in design, coverage, and benefits make it quite difficult to present an overall assessment of the importance of unemployment insurance systems as part of a comprehensive income support mechanism, there are some common traits that deserve comment. In the first place, unemployment insurance is normally a benefit provided in addition to severance payments. Once the worker is fired, he or she receives severance payments. In addition to that, the worker has the right to unemployment insurance as a supplementary source of income during his or her search for a new job. Therefore, income protection by the unemployment insurance system targets workers who have had full-benefit employment contracts. As we mentioned above, this excludes from protection a sizable fraction of the workforce that works in the unregulated segment of the labor market, presumably those who because of their human and social capital deficits are the neediest in terms of income protection.

In the second place, unemployment insurance systems generally lack connection with other labor market intermediation and placement services. Even in the cases where the UI system is operated through the Labor Ministry (as in Brazil) workers are not required to register in the intermediation service, and payment of the benefit is not contingent on verification of search effort. On the one hand, this lack of connection generates opportunity for fraud. Even if it is

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<sup>8</sup> The rationale for programs as *Bolsa Escola* in Brazil, *Programa de Asignaciones Familiares* (PRAF) in Honduras, and *Beca Alimentaria* en Venezuela is to avoid perpetuating a vicious circle of poverty. Thus, these programs require keeping children in school or attending primary health care facilities during pregnancy, as mechanisms to prevent the transmission of poverty to the next generation.

illegal to have a job and receive UI payments simultaneously, most operators complain of their lack of capacity to control what is perceived to be widespread fraud and collusion between firms and workers.<sup>9</sup> On the other hand, this lack of connection with labor market intermediation services makes the system a pure income transfer that does not ease the transition of the unemployed into a new job.

In the third place, most unemployment insurance systems are financed through payroll taxes, which are already quite high in the region. This partly explains why coverage is limited, replacement rates are low, and periods of coverage quite short. Any expansion of the system to cover hitherto unprotected segments of the population is likely to face substantial opposition by present beneficiaries and by firms operating in the regulated sector of the economy. Only in the case of Brazil has some expansion occurred (covering traditional fishermen and workers affected by the drought in the Northeast), but the expansion has been temporary and financed through the use of excess funds. If unemployment insurance is to work as part of the safety net in a crisis, the expansion of coverage would have to be produced just when the flow of benefits to already protected workers is highest, creating financial strains on the system and the need for additional funding. The question is whether this effort is worth doing through the unemployment insurance system, or by creating alternative mechanism for income transfer better suited to the needs of workers with different labor market insertions.

In the fourth place, it has been argued that the implementation of unemployment insurance requires considerable institutional resources in terms of accounting and record keeping. However, it should be noted that mandatory savings-based schemes in place in countries such as Brazil, Colombia, Ecuador, and Peru also require considerable institutional resources of the same type. Furthermore, pension system reforms in a number of countries in the region<sup>10</sup> have created a network of institutions that hold individual workers' accounts that can be used for record keeping in the unemployment insurance system with little additional cost.

In conclusion, the design and target population of unemployment insurance makes it suitable to protect workers who have full-benefit employment contracts and that acquire rights to it through their contributions while employed. In terms of labor market distortions, the low level of benefits and their short duration apparently do not create incentive against search. In fact, the reports on fraud in Argentina and Brazil rather suggest that workers use unemployment insurance as a means to obtain additional income while in a new job. As Hopenhayn and Nicolini (1999) show, it is possible to design optimal unemployment insurance schedules that do not induce reduction in search efforts. Furthermore, schemes of unemployment insurance based on nominative contributions to individual accounts, which can be rolled over into retirement funds, can minimize negative impacts on search effort.<sup>11</sup>

In terms of ability to expand and contract counter-cyclically, unemployment insurance expenditure is an ideal mechanism. By definition outlays increase when unemployment is raising and contract with the recuperation of employment.

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<sup>9</sup> Mazza (2000) reports that some efforts have been made in Argentina to detect if workers receiving unemployment insurance were working by using a common taxpayer identification number. It was found that a sizable number of workers were not only working, but also contributing to social security in a new job while continuing to receive the UI payment.

<sup>10</sup> Most notably Chile, but also Argentina, Uruguay, Peru, and Venezuela.

<sup>11</sup> For a proposal of an unemployment insurance system along these lines see Cortazar *et al.* (1995) and the Venezuelan Social Security Law of 1997.

The most problematic aspect of unemployment insurance, however, is related to its coverage. Workers must bear at least part of the cost of insurance to prevent moral hazard problems. For high productivity workers, wages are high enough to make the benefits of paying for unemployment insurance (the expected value of benefits when unemployed) higher than the current income foregone by paying the contribution. However, for low productivity workers the utility gain from an increase in current income will be large enough to generate incentives to negotiate with employers a contract without benefits in exchange for a higher current income.

## **Employment Generation Programs**

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

### *Labor-Intensive Public Works*

Labor intensive public works have been the tools of choice to deal with economy-wide shocks. The number and variety of programs in place in the region shows that governments choose to spend more additional resources in employment generation than in other mechanisms to provide income support to unemployed workers. One of the main advantages of these programs is that they are self-targeted (Grosch 1994, Ravallion 1998) and, therefore, can be implemented without the delays involved in implementing a targeting mechanism.

Three characteristics of labor-intensive public works are crucial in their success as income support mechanisms. In the first place, these programs are financed by the central government and executed by local organizations (be it local governments or NGOs), who normally are in charge of selecting the works to be performed and the selection of beneficiaries. Thus, labor intensive public works require an extensive and solid network of institutions at the local level, with the technical and operational capacity to choose the works to be done, to organize the production process, and to channel resources to the needy poor. A large part of the success of these programs hinges on how well structured the relationship is between the central government and the executing agencies.

There is not a single way of designing this relationship. To mention just two examples, Argentina chose to finance works that are approved by a central government agency and executed mostly by local governments, while Brazil chose to allocate resources semi-automatically on a regional needs basis and have works selected by the sub-national governments. In any case, what is important is that the design of the relationship between financing and work execution be adequate to the institutional and political structure of the country. More federalist countries should respect local autonomy in work selection and allocate budgets on objective criteria, while more centralized countries will be more able to select works and distribute resources at the central level while keeping responsibility for execution at the local level.

In the second place, the wage level and the criteria for selection of beneficiaries are set at the central level, while local organizations are in charge of the selection of beneficiaries. Thus, there is a certain degree of tension between the criteria set at the central level and the local political and social reality within which the selection of beneficiaries take place. There are multiple ways to solve, or at least mitigate, the consequences of this tension. Community participation is useful for oversight to ensure that resources are not diverted through political favoritism or other forms of corruption, but there is no guarantee that the needed level of

community participation will exist. A useful complement to community participation is a system of random sampling of projects and beneficiaries by the central government agency in charge of overseeing the program to check whether or not resources are being diverted. This implies a non-trivial investment of resources in sampling and supervision, but these resources will pay for themselves in more transparency and better targeting of beneficiaries.

In the third place, the virtue of self-targeting has the vice of low wages. In order to concentrate resources on needy groups and avoid inducing distortions in local labor markets, wages in labor intensive public works are frequently set below the market wage of the relevant labor market. The literature on “workfare” in the developed world suggests that this targeting mechanism is not without costs in terms of stigmatizing workers who participate in the program (Lightman, 1995), and in terms of political and social discrimination among workers by program administrators (Rose, 1994). There is no solution to this problem, short of raising wages to market levels, which in most cases will be impossible given resource constraints.

In summary, labor intensive public works do not generate important labor market distortions to the extent that they offer wages below the relevant market, and can provide a source of income to workers temporarily unemployed. Their coverage depends on the amount of resources allocated to the program, but there is no intrinsic reason why coverage of low skill workers could not be as ample as needed to reduce unemployment to the target level. This same property, however, brings us to the problem of their counter-cyclicality. Because the amount of resources dedicated to the program is a political decision, there is no way of guaranteeing that the program will move in sync with the economic cycle, expanding in downturns and shrinking in upturns. In fact, the experience in the region shows that once programs are in place it is very difficult to reduce their size. In the well known cases of programs that were phased out during the eighties (PEM and POJ in Chile and PAIT in Peru), the closing seems to have been mostly a reaction to widespread problems of design and political manipulation.

### *Wage Subsidies*

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

Wage subsidies work through reducing the payroll tax and/or severance payments in employment contracts for particular groups of workers (youth, women, ex-combatants, etc.). This characteristic makes them suitable for the introduction of more flexible (or precarious) employment contracts in a process of labor market regulation reform. In fact, this was the role these programs fulfilled in Argentina in 1995. But at the same time, this makes them the center of a political debate on labor market flexibilization, which in large measure explains why these programs were phased out as a result of union opposition in 1998.

On the other hand, because wage subsidies target particular groups, they change the relative prices of different types of workers in favor of the target group and induce large labor market distortions, not the least of which is the substitution of subsidized by non-subsidized workers.<sup>12</sup> In order to mitigate this problem, there is normally an “additionality” requirement, by

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<sup>12</sup> More formally, deadweight effects appear when the subsidized jobs would have been created anyway without the subsidy, while substitution effects appear when subsidized workers replace non-subsidized

which subsidies are granted only for new net hires that expand the payroll. In turn, this requires the determination of a baseline number of employees and a control on new hires. Theoretically this is a task that Ministries of Labor fulfill in the normal course of their operations. In practice, the ministries are extremely weak and have a very low enforcement capability. This weakness makes impossible the task of determining baselines and controlling hires of subsidized workers, thereby making worker substitution a widespread problem. As a consequence, it is not clear whether these programs really create more jobs than would have been created without the subsidy.

In summary, these programs tend to generate large and important labor market distortions by attempting to change the relative salaries of different types of workers. Because wage subsidies have to be explicitly targeted by design, they require a comprehensive and often non-existent enforcement apparatus, making the problem of targeting the program an intractable one. In terms of their counter-cyclical, expanding and shrinking the program requires an administrative decision. To the extent that these programs are often perceived as a mechanism to introduce more flexible (or more precarious) employment contracts, they can become the center of an often ardent political debate and make decisions about program implementation politically very costly. This has been the experience of Argentina, where these programs were phased out at the same time that more far reaching labor regulation reforms were rejected during 1997.

### **Short-Term Training Programs**

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

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

Training programs tend to be more expensive on a per beneficiary basis than labor-intensive public works, given that a larger part of the resources goes to pay the training provider. However, calculations of benefits should include the long-term change in the structure of the

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(Calmfors, 1994). The additionality requirement address the deadweight effect, while substitution effects are only prevented at the margin.

training system and the development of job search assistance services, which are very large positive externalities of these programs.<sup>13</sup>

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

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

### **Putting the Pieces Together**

Macroeconomic volatility seems to be a permanent feature of Latin American economies, and the adoption of growth-oriented sustainable economic policies has not reduced it. In the brave new world of higher and more pro-cyclical unemployment, the traditional legally mandated severance payment mechanisms have failed to provide the income support needed by unemployed and displaced workers. These traditional mechanisms have become irrelevant in the new environment of more open and competitive economies, given the narrow scope of their coverage. This same failure has led governments, faced with sharp economic instability since 1995, to develop a series of attempts at setting up mechanisms to support the incomes of groups of the population hurt by unemployment and declining incomes.

The pieces of the new income support system are there in most countries. However, because they were developed as emergency programs, they are more a mosaic of often unrelated initiatives than a coherent and well thought out system. As such, their ability to expand rapidly was a dominant concern. Little attention was paid to the potential labor market distortions they introduced, and even less to their ability to expand and contract in a counter-cyclical fashion. Moreover, the scarcity of resources available at the moment of their implementation called for narrow targeting of the poor, as the programs were thought of as emergency devices to protect the population that did not have the resources to protect themselves. The underlying thought was that

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<sup>13</sup> These emergency training programs have created the opportunity to introduce institutional innovation into a training system characterized by the monopolistic power of payroll tax financed institutions. Disseminating these innovations to the mainstream vocational training system will make it much more successful in addressing the needs of skill upgrading of workers caught in the normal process of job churning.

the traditional income support mechanism based on severance payments served to protect the non-poor.

The starting point for a new income support system is the recognition that workers in general, and not only the poor, need to count on mechanisms to help them cope with both economy-wide and idiosyncratic shocks that result in income losses and unemployment. The protection of the severance payment system covers today no more than half the labor force and has a high cost in terms of labor market distortions. As has been argued extensively elsewhere (e.g., Inter-American Development Bank, 1997) more socialized forms of income protection, such as unemployment insurance, can provide effective protection and cost less in terms of labor market distortions. In this sense, some of the recent labor market reforms (exemplified by the Venezuelan reform of 1997), which reduce legally mandated severance payments and create a system of unemployment insurance, represent a step in the right direction.

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

**Table 6: The Design of an Income support system**

| <b>Program</b>  | <b>Targeting</b>   | <b>Financing</b>   | <b>Institutional Requirements</b>   |
|---|--|--|---|
| <b>Unemployment insurance</b>   | Non-targeted, covering all workers in regulated contracts (in lieu of severance payments). | Financed from workers' and firms' contributions.           | Independent financial institution(s). System connected to pension system.                                 |
| <b>Scholarships for short-term classroom training, apprenticeships, and job search assistance</b> | Unemployed youth   | Financed from training system payroll tax.                 | Opening of the market for training services. Network of non-government providers.                         |
| <b>Employment generation programs</b>   |  |  |   |
| <ul style="list-style-type: none"> <li>Labor intensive public works</li> </ul>                    | Self-targeting.  | Financed from general revenues, strongly counter-cyclical. | A solid network of local institutions able to apply selection criteria and to implement works' execution. |
| <ul style="list-style-type: none"> <li>Wage subsidies</li> </ul>                                  | Administrative.  | Exemption of payroll taxes, financed by general revenues.  | Sophisticated enforcement and verification system from labor authority.                                   |
| <b>Cash transfers</b>   | Very narrow, based on family income below the poverty line.                                | Financed from general revenues.                            | Sophisticated targeting system.   |

A very general vision of the components of an income support system is presented in Table 6. At the center of the scheme, a well-designed unemployment insurance system covers the group of workers that, given their employment contracts and their productivity, can “buy” the insurance. Both individual accounts and collective insurance are needed in order to prevent moral hazard and to extend as much as possible the coverage of the system. The rationale for the implementation of the collective insurance component is that workers who suffer more frequent or more prolonged unemployment episodes can “borrow” against future deposits. The Chilean Ministry of Labor proposed a good example of this type of unemployment insurance in 1993 (see Cortazar *et al.*, 1995), and the recent reform of the social security system in Venezuela contemplates an unemployment insurance system along the same lines.

Mandatory-savings based schemes (the so-called “separation funds” in Brazil, Colombia, Peru, and Venezuela) mimic a number of the desirable characteristics of unemployment insurance and can serve as an alternative basis for protecting the income of workers in regulated employment relations.

For workers who do not have access to unemployment insurance a variety of mechanisms need to be put in place, depending on the reasons for these workers’ lack of access. In the first place, short-term training courses could provide low skill new entrants with the training, labor market experience, and job search assistance necessary to access a regular job. Scholarships should be set at a level low enough as to not discourage search in the local labor market,<sup>14</sup> and targeting should concentrate resources on out-of-school unemployed youth. Careful attention should be given to attract exclusively individuals out of the school system, and therefore to deter school desertion pulled by the program. Financing of this program should be obtained from the existing payroll tax earmarked for training, maintaining the system of decentralized provision with apprenticeships. Funding should be provided in sync with demand for these services, higher during economic downturns and lower during expansions. However, to the extent that the training system unifies around the decentralized model of provision, a continuous level of funding should be provided to help all workers deal with normal job churning, while the youth component adjusts to the economic cycle as a function of the evolution of the youth unemployment rate.

For displaced low skill workers, labor-intensive public works are the tools of choice in order to provide them with jobs at the local level. As we mentioned above, in the design of these programs it will be necessary to take into account the level of development of local governments, and the nature of their financial and political relationship with the central government. Many initiatives to set up employment generation programs have failed for not taking into account the organizational and political dimension of the separation between financing and execution. Again, wage levels in the programs should be low enough so as not to crowd out alternative employment opportunities. Funding should be provided from general revenues and not, as is normally done, from payroll tax revenue.<sup>15</sup> Again, funding should be provided in sync with demand, with expenditure adjusting according to the evolution of the general or, if available, local unemployment rates.

The other member of the family of employment generation programs, wage subsidies, should be used sparingly if at all, in spite of the conceptual attractive of the idea of generating

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<sup>14</sup> The main criteria here is that the scholarship should be below the market wage that *equivalent workers* obtain in the labor market, and not in function of the overall average wage.

<sup>15</sup> The use of payroll tax resources (which increase the cost of labor and therefore reduce employment generation) to generate jobs is somewhat contradictory in terms.

private sector “real” jobs (as opposed to the “make work” jobs of labor-intensive public works). The distortions caused by meddling with the relative wages of different types of workers are important enough to recommend caution in this area. Besides, the sophisticated enforcement and supervision system needed to mitigate the deadweight and substitution effects of these subsidies is not present in most of countries.

Finally, cash transfers to poor families are the *last resort* mechanism to support those families that “fall through” the other support mechanisms. As a mechanism of last resort a signal of good implementation is low coverage. If coverage rises to a well-defined poverty head count there is a clear signal that other components of the income support system are failing, and too many workers are “falling through.” The complication of their design and implementation are well known,<sup>16</sup> and extreme caution is recommended given that the program can create dependency traps for beneficiaries.

This set of programs and mechanisms, centered on unemployment insurance and encompassing other complementary mechanisms to protect more vulnerable workers, is a quite comprehensive system of income support. As such, the system as described is more a statement of purpose than a guide for action. Political realities and implementation abilities will determine what part of a labor market-based income protection system can be implemented in a given country at a given time. As a vision of purpose it could be useful to put emergency measures into a more structured framework of long term objectives. Most of the components of this comprehensive system exist in one form or another in most countries in the region. Setting some of them (as replacing legally mandated severance payments by unemployment insurance or saving-based separation funds) will require far-reaching political agreements, but these agreements can only be facilitated by sharing a vision of the end product as a system to protect all workers against income volatility. In other cases (as in designing emergency employment programs) the pitfalls of designing in the context of an emergency can be to some extent mitigated by a vision of how the emergency program will fit in the context of a new and more effective income protection system.

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<sup>16</sup> For a summary of state-of-the-art arguments on cash transfers see Family Allowances Program, Phase II, Loan Proposal (HO-0132), IADB, Project Report 2354.

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**Table A-1: Employment Generation Programs in Seven Countries in the Region**

|  | Beneficiaries |                        | Expenditure          |              |
|--|---------------|------------------------|----------------------|--------------|
|  | 1,000s        | % of total labor force | 10 <sup>6</sup> US\$ | % GDP        |
| <i>Argentina</i>   |               | <b>9.31%</b>           |                      | <b>0.09%</b> |
| <b>Public works financed with public resources</b>   |               |                        |                      |              |
| 1. <b>Programa de Asistencia Solidaria (PROAS)</b><br>Unemployed household heads in public works executed jointly by Sec. Desarrollo Social and state governments                            | 260.0         | 2.7%                   | 54.5                 | 0.020%       |
| 2. <b>Programa de Entrenamiento Ocupacional (PRENO)</b>  | 94.0          | 1.0%                   | 20.0                 | 0.007%       |
| 3. <b>Programa de Servicio Comunitario (ASISTIR)</b><br>Female household heads in community development activities   | 25.0          | 0.3%                   | 2.6                  | 0.001%       |
| 4. <b>Programa Trabajar</b><br>Unemployed household heads in public works executed by local governments and NGOs.  | 233.0         | 2.4%                   | 44.9                 | 0.017%       |
| <b>Private sector employment promotion</b>   |               |                        |                      |              |
| 5. <b>Programa de Empleo Privado para Pequeñas y Medianas Empresas</b><br>Subsidy for new jobs for unemployed workers in firms with less than 100 employees                                  | 254.0         | 2.7%                   | 42.4                 | 0.016%       |
| 6. <b>Programa Nacional de Forestación Intensiva (FORESTAR)</b><br>Subsidy for new jobs for unemployed workers in new agricultural/forestry firms.   | 21.0          | 0.2%                   | 4.4                  | 0.002%       |
| 7. <b>Programa de Reinserción Laboral</b><br>Subsidy to workers that find a job while receiving unemployment insurance.  | n.a.          |                        | n.a.                 |              |
| 8. <b>Programa de Movilidad Geográfica</b><br>Subsidy to workers that have to move from place of residence to keep the job.  | n.a.          |                        | n.a.                 |              |
| 9. <b>Bono para la creación de empleo privado (BOCEP)</b><br>Fiscal credit for workers displaced from states' payroll. New employer can use as collateral for credit from public banks.      | 5.2           | 0.1%                   | 73.4                 | 0.027%       |
| <i>Brazil (1)</i>  | 221.8         | <b>0.49%</b>           | 1,188.8              | <b>0.21%</b> |
| 1. <b>Programa de Generación de Empleo e Ingresos (PROGER)</b><br>Special credit lines to MSMEs, cooperatives and informal sector.   | 221.8         | 0.5%                   | 1,188.8              | 0.21%        |
| <i>Chile</i>   | 4.3           | <b>0.10%</b>           | 1.4                  | <b>0.00%</b> |
| 1. <b>Trabajadoras temporeras</b><br>Child-care and educational services for children of ag. Temporary workers   | 4.3           | 0.1%                   | 1.2                  | 0.002%       |
| 2. <b>Programa de desarrollo del microempresario indígena</b><br>Strengthening of economic networks of indigenous groups through ME creation and support                                     | n.a.          |                        | 0.2                  |              |
| <i>Costa Rica</i>  | 8.1           | <b>0.71%</b>           | 3.3                  | <b>0.04%</b> |
| 1. <b>Programa nacional de generación de empleo</b><br>Transfer of a min. wage to unemployed workers who participate in construction of social services infrastructure and service delivery. | 2.1           | 0.2%                   | 0.1                  | 0.001%       |
| 2. <b>Pro Trabajo</b><br>- <i>Incentivos para la reinserción laboral y el empleo temporal</i><br>Subsidy of 50% of min. wage for on-the-job-training for unemployed/vulnerable workers.      | 3.4           | 0.3%                   | 2.1                  | 0.026%       |
| - <i>Ideas productivas</i><br>Support to ME creation.  | 2.6           | 0.2%                   | 1.1                  | 0.013%       |

**Table A-1, continued**

| <i>Jamaica</i>  | 6.0     | <b>0.61%</b> | 21.2    | <b>0.50%</b> |
|---|---------|--------------|---------|--------------|
| 1. <b>Micro Investment Development Agency (MIDA)</b><br>Credit for ME development   | 6.0     | 0.6%         | 7.6     | 0.181%       |
| 2. <b>The Government of Jamaica/Government of the Netherlands Micro Enterprise Project (GoJ/GoN MEP)</b><br>Credit for ME development   | n.a.    |              |         | 0.000%       |
| 3. <b>The Government of Jamaica/European Union Programme</b><br>Credit for ME development   | n.a.    |              | 1.4     | 0.034%       |
| 4. <b>Mel Nathan Institute for Development and Social Research (MMI)</b><br>Community development services  | n.a.    |              | 1.6     | 0.038%       |
| 5. <b>Enterprise Development Trust (EDT)</b><br>Credit for ME development   | 0.0     | 0.0%         | 0.2     | 0.004%       |
| 6. <b>The Women's Construction Collective (WCC)</b><br>Training and credit for female construction workers  | n.a.    |              | n.a.    |              |
| 7. <b>ASSIST Ltd.</b><br>Credit for ME development  | n.a.    |              | 0.1     | 0.002%       |
| 8. <b>Bee Keeping and Honey Bee Project</b><br>Training and employment for youth in bee-keeping activities.   | n.a.    |              | 0.3     | 0.007%       |
| 9. <b>SESP</b><br>Training and temporary employment for unemployed workers  | n.a.    |              | 10.0    | 0.237%       |
| <i>Mexico</i>   | 1,024.0 | <b>4.42%</b> | 1,802.0 | <b>0.51%</b> |
| 2. <b>Programa de Conservación de Caminos Rurales</b><br>Rural public works for unemployed youth, Federal Govt. financed, works organized by state and local governments.   | 712.0   | 3.1%         | 350.0   | 0.099%       |
| 3. <b>Progr. de Construcción de Infraestructura Física y Obras de Empleo Productivo</b><br>Social infrastructure public works for unemployed youth, Federal Govt. financed, works organized by State and local governments. | 312.0   | 1.3%         | 1,452.0 | 0.410%       |
| 4. <b>Programas Sociales Privados Club de Leones y Rotarios</b>   | n.a.    | n.a.         | n.a.    | n.a.         |
| <i>Peru (2)</i>   | 27.8    | <b>0.93%</b> | 0.1     | <b>0.19%</b> |
| 1. <b>Progr. de autoempleo y microempresa (PRODAME)</b><br>Training and credit for ME creation and support  | 4.2     | 0.1%         | 0.1     | 0.000%       |
| 1. <b>FONCODES</b><br>Social investment fund builds small public works using local work-orce.   | 23.6    | 0.8%         | 100.0   | 0.002%       |

(1) PROEMPREGO is excluded from the Brazilian list of employment generation programs, as it is an investment program, with obvious employment consequences, but with the primary objective of improvements in sanitation, environmental infrastructure, urban transport, etc. through BNDES lines of credit.

(2) Peru has also implemented a number of its employment generation programs as labor intensive investments sub-projects, complementary to the normal investment activities of institutions such as Instituto Nacional de Desarrollo (INADE), Programa Nacional de Asistencia Alimentaria (PRONAA), Empresa Nacional de Edificaciones (ENACE), Fondo Nacional de la Vivienda (FONAVI), Instituto Nacional de Infraestructura Educativa y de Salud (INFES), SEDAPAL, CORDECALLAO, CORDELIMA, INABIF, Fondo de Compensación Municipal, PROMANACHCS (Min. Agricultura), Ministerio de Transporte.

**Table A-2: Training Programs in Seven Countries in the Region**

|  | Beneficiaries |                        | Expenditure          |              |
|--|---------------|------------------------|----------------------|--------------|
|  | 1,000s        | % of total labor force | 10 <sup>6</sup> US\$ | % GDP        |
| <b>Argentina</b>   | 133.0         | <b>1.4%</b>            | 95.6                 | <b>0.04%</b> |
| <b>1. Proyecto Joven</b><br>Scholarships and stage in temporary job for low-income, unskilled, unemployed youth.   | 53.0          | 0.6%                   | 71.7                 | 0.027%       |
| <b>2. Proyecto de Microemprendimiento</b><br>Entrepreneurship training for experienced, unskilled workers  | 5.4           | 0.1%                   | 6.5                  | 0.002%       |
| <b>3. Programa Imagen</b> (Orientación para el empleo)<br>Job-search assistance  | 27.0          | 0.3%                   | 1.2                  | 0.000%       |
| <b>4. Programa de Talleres Ocupacionales</b> (PTO)<br>Support to NGOs in setting up training institutions  | 18.0          | 0.2%                   | 4.2                  | 0.002%       |
| <b>5. Programa de Capacitación Ocupacional</b><br>Training of unemployed and SMEs personnel  | 24.0          | 0.3%                   | 7.3                  | 0.003%       |
| <b>6. Programa de Capacitación para el Empleo</b><br>Scholarships and stage in temporary job for low-income, unskilled, unemployed and displaced workers                   | 1.7           | 0.0%                   | 2.3                  | 0.001%       |
| <b>7. Programa Aprender</b><br>Financing of health and accident insurance for young workers hired under <i>Contratos de Aprendizaje</i>                                    | 1.9           | 0.0%                   | -                    |              |
| <b>8. Programa Emprender</b><br>Financing of training cost for workers in new firms.   | 2.0           | 0.0%                   | 2.4                  | 0.001%       |
| <b>9. Programa de Crédito Fiscal</b><br>Tax exception for training firms.  | n.a.          |                        | n.a.                 |              |
| <b>Brazil</b>  | 740.5         | <b>1.6%</b>            | 310.2                | <b>0.06%</b> |
| <b>PLANFOR</b><br>FAT-financed training program executed at the federal and state level by independent training institutions.  |               |                        |                      |              |
| <b>1. Programas Federales y Estatales</b><br>Federal and state programs for vulnerable groups.   | 340.8         | 0.7%                   | 149.8                | 0.03%        |
| <b>2. Programas de Emergencia</b><br>Emergencies from drought and declining/restructuring sectors  | 399.7         | 0.9%                   | 159.4                | 0.03%        |
| <b>Chile</b>   | 36.6          | <b>0.8%</b>            | 18.3                 | <b>0.03%</b> |
| <b>1. Programa Chile joven</b><br>Stipend and stage in temporary job for low-income, non-skilled, unemployed youth.  | 17.9          | 0.4%                   | 10.4                 | 0.019%       |
| <b>2. Programa de apoyo a mujeres jefas de hogar de escasos recursos</b><br>Training, day-care, health and other services to improve labor market insertion of poor women  | 15.0          | 0.3%                   | 4.9                  | 0.009%       |
| <b>3. Mujer y microempresa</b> (Capacitación en gestión empresarial con perspectiva de género)<br>Entrepreneurship training for female household heads with some education | 0.1           | 0.0%                   | 0.3                  | 0.001%       |
| <b>4. Programa de reinserción laboral</b><br>Job search and relocation assistance to displaced workers from carbon and textile workers.                                    | 0.2           | 0.0%                   | 0.8                  | 0.002%       |
| <b>5. Programas regulares de becas</b><br>Scholarships for training at official institutions for vulnerable groups (temporary workers in agriculture, ports and fishing)   | 1.3           | 0.0%                   | 0.3                  | 0.001%       |

| <b>Table A-2, continued</b>   |                      |                        |                      |              |
|---|----------------------|------------------------|----------------------|--------------|
|   | <b>Beneficiaries</b> |                        | <b>Expenditure</b>   |              |
|   | 1,000s               | % of total labor force | 10 <sup>6</sup> US\$ | % GDP        |
| <i>Chile, continued</i>   |                      |                        |                      |              |
| 7. Programa de capacitación e inserción laboral para personas con discapacidad  | 0.6                  | 0.0%                   | 0.9                  | 0.002%       |
| 8. Programa de rehabilitación, capacitación e inserción laboral para personas discapacitadas  | 0.2                  | 0.0%                   | 0.1                  | 0.000%       |
| 9. Programa de formación y capacitación para el trabajo.<br>Adult training program privately operated.  | 1.2                  | 0.0%                   | 0.4                  | 0.001%       |
| <b>Costa Rica</b>   | <b>13.1</b>          | <b>1.2%</b>            | <b>60.6</b>          | <b>0.73%</b> |
| 3. Llave en mano<br>Contracting out of training activities by the public training institution (INA)   | n.a.                 |                        | n.a.                 |              |
| 5. Formación y reconversión para los movilizados<br>Training for displaced public sector workers  | 1.5                  | 0.1%                   | n.a.                 |              |
| 6. Talleres públicos<br>Training of low-income workers in marginal urban areas  | 6.2                  | 0.6%                   | n.a.                 |              |
| 7. Formación profesional para el desarrollo socio laboral de personas con discapacidad<br>Training of handicapped workers                                       | 1.0                  | 0.1%                   | n.a.                 |              |
| 8. Prog. de becas de capacitación para el empleo del Ministerio de Trabajo y Seguridad Social<br>Scholarships for training of workers with secondary education. | 4.4                  | 0.4%                   | 0.1                  |              |
| <b>Jamaica</b>  | <b>43.5</b>          | <b>4.4%</b>            | <b>18.6</b>          | <b>0.44%</b> |
| 1. Skills 2000<br>Training for out-of-school and unskilled unemployed workers   | 40.0                 | 4.1%                   | 11.4                 | 0.3%         |
| 2. Special Training Empowerment Programme (STEP)<br>Youth training  | 0.6                  | 0.1%                   | 4.6                  | 0.1%         |
| 3. Strategies to Rehabilitate Inner Cities through Viable Enterprises (VIABLE)<br>Urban youth training  | n.a.                 |                        | n.a.                 |              |
| 4. National Youth Service (NYS)<br>Training temporary employment for unemployed youth   | 2.9                  | 0.3%                   | 2.6                  | 0.06%        |
| <b>Mexico</b>   | <b>410.3</b>         | <b>1.8%</b>            | <b>135</b>           | <b>0.04%</b> |
| 1. Programa de Becas de Capacitación para Desempleados (PROBECAT)<br>Training and scholarships for unemployed workers   | 410.3                | 1.8%                   | 135                  | 0.038%       |
| <b>Peru</b>   | <b>1.5</b>           | <b>0.1%</b>            | <b>5.0</b>           | <b>0.01%</b> |
| 1. Programa de Capacitación Laboral Juvenil (PROJOVEN)<br>Scholarships and training for unemployed youth  | 1.5                  | 0.1%                   | 5.0                  | 0.01%        |