The Challenge of Reforming Social Security in Latin America

Francisco Eduardo Barreto de Oliveira

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THE CHALLENGE OF REFORMING SOCIAL SECURITY IN LATIN AMERICA

Francisco Eduardo Barreto de Oliveira

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1. INTRODUCTION

Reforming Social Security systems in Latin America is doubtless a huge challenge. Differently from other parts of the underdeveloped world, most Latin American Countries had have Social Security systems for quite a long time, often offering very generous benefits to certain population groups.

Not by chance, these groups are usually the most economically affluent and/or most politically powerful of society. Through the political struggle, they actually managed to have access to some privileges. Obviously, they fight quite fiercely to keep the status quo, using all the power and weapons they originally used to get the privileges.

As a consequence of this real world political reality, and sometimes despite any theoretical considerations, the very fundamental question that arises is why to reform Social Security at all?

This paper focuses on some of the basic issues that are common to most Latin American countries in terms of Social Security reform debate, giving special attention to Brazil, Chile, Argentina and Venezuela.

Of course, all generalizations incur in some degree of simplification. As a matter of fact, the various aspects that are going to be discussed here are common to the countries, but are not homogeneously important among them. More than that, even if they were equal, they could be perceived very differently by the public opinion and by the politicians of each country, leading to different paths in terms of decision making.

In fact, this paper has no intention of comparing systems of one country to systems of another country. The Chilean reform is often used as a basis for examples for two reasons: first, the reform was a radical departure from conventional systems; second, the author had the opportunity of visiting that country in 1991. This last fact to which one has to add the very information rich chilean report, contributed to this special treatment.

As usual, this paper expresses only personal opinions and neither reflects the official position of IPEA, nor the Brazilian government's, nor of the inter-American Development Bank. The author would also like to acknowledge the contributions of Dr. Kaizo Iwakami Beltrão and Dr. André César Médici, consultants to IPEA. Of course, the author assumes full responsibility for eventual mistakes.
2. THE CONCEPTUAL ISSUE

The conceptual issue is very critical when discussing Social Security not only in Latin America but everywhere. Far from an academic question, the right conceptual framework is essential to a rational discussion of the various particular issues.

What is really Social Security? Some tend to view it as an insurance-like scheme: the citizen pays contributions in order to have some basic social risks covered. Others, view it as social assistance: society as a whole must pay contributions for the collective protection against social risks.

A good starting point would perhaps be the definition of what is a basic social risk. Of course, this definition varies according to the values of each society, but in general, sickness, disability, premature death, and, sometimes, unemployment, are generally recognized as basic social risks of the non-programmable type. Old age — that in fact, is presumed disability — and, very rarely, length of service, are basic social risks of the programmable type.

To this basic list of social risks many others can be added, depending on economical, social, cultural, and political factors: maternity, large family, housing, food etc. benefits are commonplace in many Social Security systems all over the world.

Social Security can be defined as the set of policies and actions, covering social insurance, health and social assistance, aiming to cover basic social risks.

As simple as it may appear at a first glance, this definition is in fact very complex if examined closer. First, pure insurance, even when through mutuality, is non-redistributive in essence: indemnizations are paid proportionally to the premium. On the other extreme, pure assistance is paid according to need, independent of contribution.

Is Social Security insurance or social assistance? The answer is ambiguous: usually, real world systems are different mixes of both concepts. To be more precise, different components of each system have different levels of insurance and social assistance. For example, the social insurance component has more to do with insurance related principles and practices than the health components.

To make things simpler, let us stay just with the social insurance component. If its to be more like an
insurance type of mechanism, there is, in principle, no justification for a ceiling on the salaries/earnings covered. Benefits not socially justified, such as the length of service benefit can be included, as long as the individually calculated contributions cover the actuarial costs. The idea in such systems is that fair insurance is one where the expected present value of contributions paid equals the expected present values of benefits/services received.

If its an assistance type of system, it has to be very clear to all participants, specially to legislators, that these discounted present values simply cannot be equal. To redistribute something means that someone will get more than he contributed to the system.

In sense, the concepts of insurance and assistance are opposites. Social Security systems are somewhere in between. They try to preserve the insurance image while, in fact, doing some degree of income redistribution.

3. THE ISSUE OF COVERAGE

As a consequence of their non-planned historical development, Latin American Social Security Systems (LASS) tend to have very unequal coverage. As demonstrated by Table 1, in 1980, coverage varies from 96.30% for Brazil to 0.76% for Haiti.

These numbers can be very misleading, if the real concept of coverage is not taken into account. For example, for Brazil, the 96.30% coverage means the existence of some type of pecuniary benefits from the social insurance subsystem, or some type of medical service or some type of social assistance. In other words, the apparently high coverage hides, as for most countries of the region, a huge internal inequality in the provision of benefits and services among different population groups, across different regions of each country.

Some countries tried to make Social Security coverage universal. It is a politically attractive goal, but the results are, at least, confusing to the contributors of the old social insurance system. Given the large informal sector and the short or non-existing waiting time, the rule is to divert contributions previously assigned to social insurance to new health or social assistance programs. As a consequence, society ends up perceiving this maneuver as the breaking of the insurance contract, virtually a fraud against old participants. Social assistance and health can and perhaps should be universal. Social insurance cannot,
simply because there are certain individuals that cannot afford the contributions.

TABLE 1

<table>
<thead>
<tr>
<th></th>
<th>TOTAL POPULATION (Thous.)</th>
<th>TOTAL INSURED (Thous.)</th>
<th>COVERAGE (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>28,237</td>
<td>22,278</td>
<td>78.90</td>
</tr>
<tr>
<td>Bolivia</td>
<td>5,570</td>
<td>1,412</td>
<td>25.35</td>
</tr>
<tr>
<td>Brazil</td>
<td>121,286</td>
<td>116,800</td>
<td>96.30</td>
</tr>
<tr>
<td>Chile</td>
<td>11,104</td>
<td>7,418</td>
<td>66.80</td>
</tr>
<tr>
<td>Colômbia</td>
<td>25,247</td>
<td>2,925</td>
<td>11.59</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>2,279</td>
<td>1,733</td>
<td>76.04</td>
</tr>
<tr>
<td>Cuba</td>
<td>9,724</td>
<td>9,724</td>
<td>100.00</td>
</tr>
<tr>
<td>Dominican Rep.</td>
<td>5,558</td>
<td>440</td>
<td>7.92</td>
</tr>
<tr>
<td>Ecuador</td>
<td>8,021</td>
<td>636</td>
<td>7.93</td>
</tr>
<tr>
<td>El Salvador</td>
<td>4,797</td>
<td>300</td>
<td>6.25</td>
</tr>
<tr>
<td>Guatemala</td>
<td>7,480</td>
<td>1,064</td>
<td>14.22</td>
</tr>
<tr>
<td>Haiti</td>
<td>5,809</td>
<td>44</td>
<td>0.76</td>
</tr>
<tr>
<td>Honduras</td>
<td>3,955</td>
<td>288</td>
<td>7.28</td>
</tr>
<tr>
<td>México</td>
<td>69,393</td>
<td>37,056</td>
<td>53.40</td>
</tr>
<tr>
<td>Nicaragua</td>
<td>2,771</td>
<td>253</td>
<td>9.13</td>
</tr>
<tr>
<td>Panamá</td>
<td>1,956</td>
<td>985</td>
<td>50.36</td>
</tr>
<tr>
<td>Paraguay</td>
<td>3,168</td>
<td>575</td>
<td>18.15</td>
</tr>
<tr>
<td>Peru</td>
<td>17,295</td>
<td>3,016</td>
<td>17.44</td>
</tr>
<tr>
<td>Uruguay</td>
<td>2,908</td>
<td>1,993</td>
<td>68.54</td>
</tr>
<tr>
<td>Venezuela</td>
<td>15,024</td>
<td>6,790</td>
<td>45.19</td>
</tr>
</tbody>
</table>


Most of the issues that follow are derived from this first one. If the definition of the real conceptual framework is not well defined to its participants, Social Security discussions will remain as an obscure game, with no defined rules, and a lot of ideological, demagogic and, sometimes, irrational components. It has to be clear to all participants, which parts are insurance, and which are assistance; who pays and who benefits from each component of the system.

4. THE ISSUE OF INEQUALITY

As stated above, some LASS do have substantial horizontal coverage but this does not mean homogeneity of treatment neither social justice. In fact, it is quite frequent the situation where those who need the least social protection get the most from the systems.
Very often, even those who pay more to the system get the least.

A good example of this distortion is the existence of the length of service retirement benefit. Poorer people very seldom manage to keep records of their work lives in order to proof length of service. Actually, they usually change jobs more frequently, having more unemployment time in between jobs, and going sometimes to the informal sector work positions. Even when they manage to retire by length of service, they tend to have a somewhat lower life expectancy as compared to their wealthier counterparts. In Summary, if we do an individual actuarial balance, it is very easy to find out that poor people do have the present value of their contributions in relation to expected present value of benefits received far greater than better off groups.

This inverse Robin Hood syndrome, could be expected as the result of the political struggle of socioeconomic groups with very unequal powers. As could also be expected, most LASS just reflect the large inequalities that are characteristic of Latin American societies.

The issue here is thus, how to reform systems that are usually good for the minorities of relatively wealthy, vocal and, most of the times politically powerful citizens who support it, against the poor, silent and politically weak majority of citizens that actually need social protection?

For certain, this is a formidable challenge, specially in countries where the general public awareness regarding social policies is very low.

5. THE ISSUE OF LOW PUBLIC AWARENESS

If the relevant information is confined to the elites and to the LASS bureaucrats, it is very difficult to have a rational discussion of Social Security issues. One of two situations usually arise: either the marginalized populations do not get involved at all, and the unfair systems just stands as it is, or some demagogic proposal of generalizing privileges gets full public support. The results are, in either case, very bad; extreme inequality in the first, or bankruptcy in the second.

Chile and Brazil are two good examples. Prior to the reform, the Chilean system offered very segmented and differential benefits to some special groups. The attempt to generalize this privileges led to bankruptcy and to the need of a radical reform. In the case of Brazil, the 1988 Constitution generalized to the whole population some unjustifiable benefits, such as a
benefit floor equal to one minimum wage, what is more than the floor a worker gets as take-home pay. Although real bankruptcy has been postponed mainly by tax hikes, the future outlook is far from bright.

6. THE ISSUE OF COST CONSCIOUSNESS

One of the particular aspect of the lack of public awareness is what we could call the lack of cost consciousness. Most LASS where conceived according to Bismarck model, funded by employee, employer and State contributions. These contributions, theoretically equal, equally in theoretical terms, would give to each economic entity equal burden in supporting the systems.

Reality turned out to be very different. First, as can be seen in Table 1, these shares are very far from equal. As the economic-financial situation of most systems deteriorated, the burden of paying for the system was gradually shifted to the employers. At a first glance, it may seem as good and fair: wealthy businessman paying more is the image that immediately comes to one’s mind.

A closer look to the question, reveals just the opposite. Since in most Latin American countries the formal sector of the economy is very often a perfect example of oligopoly, price increases are, in the major part, shifted to product prices. As a consequence, all consumers pay for the bill, including those in the formal and informal labor market. Since the last group do not usually get full benefits, the system tends to be unfair.

It has also to be noted that depending on the price-consumption pattern of each society, the burden of indirect taxes may penalize - and very often do - more than proportionally low income consumers, making the system even more unfair.

As a result, the contributions are mostly invisible to tax/payers because they do not hurt their pockets directly; the perception of the real costs of employer paid contributions is, thus, severely distorted.

A similar but even worst fact occurs with the State contribution to LASS. In general, society tends to see these contributions as paid by an abstract entity - the National Treasury, as it could generate resources from now here. In fact, as previously noted, most Latin American countries have a tax structure that is heavily

1Considering the deduction of the employee’s share of the Social Security tax.
dependent on indirect taxes, usually with low education taxpayers. It can be expected that the perception that all State Money come from taxes that are paid, at the end, by the individual would be very hard to thrive in such adverse environment.

In their turn, politicians from the extreme left to the extreme right, tend to blame the insufficient contributions of the State as the very basic cause of eventual (and, more often, chronicle) Social Security deficits. Just to give a single example how the legislation itself can be misleading to the common citizen, in Brazil, it states that the government is responsible for covering all financial deficits of Social Security. It is very easy to guess what happens with cost consciousness in a situation like that.

7. THE ISSUE OF COMPULSORY VERSUS VOLUNTARY SAVINGS

Every time Social Security reforms are discussed, the ultra-orthodox approach of no compulsory savings is raised. In fact, neoclassical economics say that, under very special conditions, compulsory savings lead to less efficient use of resources.

In Social Security, these special conditions are not met by the consumer in general. First of all, information about the future opportunities for investment is usually very scarce and uncertain. Even if all the needed information were available, the calculations for a rational consumption-savings-investment decision would be rather complex, certainly beyond the reach of our average consumer.

Second, the time span over which decisions should be taken would be very long: a lifetime. This fact, in turn, tends to add more uncertainty to the decision process.

Third, individual risks may be unreasonable high. The principle of pooling risk is long known in the insurance business.

Fourth, there exists what is called the adverse selection phenomenon. In other words, if we could divide the population among risk lovers and risk averse, only the last group would tend to join a voluntary insurance scheme. The immediate consequence is that insurance premiums tend to get higher and higher, as more and more risk averse join the risk lovers group, kicked out of the first group by the growing price of insurance.
Fifth, in every society there is always a group of imprudence, that will not save at all in the absence of compulsory rules in this direction. This group would become beggars if they lose their earning capacity due to old age, disability etc., and would probably survive on public charity. For those, compulsory Social Security is more than a humanitarian need, but it is an economically justified one. In fact, it would probably cost society more to bear the burden of public charity than the inefficient use of resources due to compulsory savings.

In Latin America, where consumption levels are usually very low for the majority of the population, the risk group is enormous, for the very simple fact that no one is expected to postpone to the future the consumption that is not enough to cover basic needs in the present. According to this approach, compulsory Social Security just distributes hardship more evenly along the individual's lifetime.

For all these arguments, some kind of compulsory Social Security is needed. The basic question is the level that is socially and economically desirable and feasible.

8. THE ISSUE OF REPLACEMENT LEVELS AND REPLACEMENT RATES

If one agrees that Social Security has to cover nothing but basic risks, it may be the case that replacement levels - defined as the maximum salary/earnings covered - should be low. As for the replacement rates - defined as the ratio between benefit value and contribution salary - they may vary according to the risk covered as well as with the salaries/earnings themselves.

In other words, the maximum salary/earnings paid by the Social System and its relationship to the insured salary/earnings is usually a function of the type of risk involved and may vary inversely with the magnitude of the salary/earnings. For example, disability benefits should, in principle, have higher replacement levels that old age benefits. Some redistribution can be attained if, for the same risk covered, higher value salaries/earnings get comparatively lower benefits: as higher is the salary/earnings covered, is lower the replacement rate.

What happens in some LASS is that maximum salaries covered and benefit levels, as well as replacement rates, are, at least theoretically, very high. Brazil is a good example: the highest salary/benefit is, by
law, equivalent to 10 minimum wages, with a replacement rate that may reach 100%.

Note that, in these cases, the system is not limited to the basic coverage of social risks nor it is redistributive. There are thus strong basis for a technical argument against excess compulsory savings and system’s inequality. The question here is, once more, a political one. Most LASS where sold as insurance, much similar to private schemes, with no redistribution at all.

As a natural consequence, old participants feel their money has been stolen to finance socially oriented programs. Given the past of most LASS, it is nothing but obvious this type of political resistance to change. In some situations, where taxes are levied on salary/earnings base higher than benefits paid, and where no distinction is made between funding of the social insurance, health and social assistance, this uproar is more than justifiable. Participants do feel cheated if they do not know how much they are contributing and for which benefits they are contributing for.

Perhaps the only way to go towards a reform of Social Security systems that have this feature may be trough the dissemination of information and time. Under a democratic decision making process changes may only occur when those who actually benefit from them have enough information and political power to fight and win those who benefit with the maintenance of the status-quo.

9. THE ISSUE OF DEFINED BENEFIT VERSUS DEFINED CONTRIBUTION

Except for the new Chilean system, LASS are predominantly of the defined benefit type. In other words, cash benefits of the social insurance component are fixed, usually as a fraction of the average salary/earning base during certain period of time prior to retirement. Although the replacement rate may value according to the type of risk/benefit, it is defined and known at each point in time; it does not depend on any factors other than the risk, the base and the benefit rules.

This makes a lot of sense when one is talking about non-programmable events, such as disability, sickness, premature death and non-voluntary unemployment. As a matter of fact, these are the events that do need social insurance.
Programmable events, such as old age and length of service definitely do not have the risk component, that is the very basic factor for the existence of the insurance activity. For these type of events, social insurance coverage may use a defined benefit, defined contribution or mixed scheme.

As a matter of fact, provided the existence of a minimum benefit, there is no reason for a defined benefit scheme paid by the Social Security system for the events of old age and length of service. Over and above the minimum social benefit, one can see the system as a compulsory savings instrument, that can be justified only by reasons beyond those of consumer rationality and social protection. The Chilean reform indicates that a relatively high level of compulsory savings might have some very good effects on the macroeconomics scenario. Unfortunately, it also have very bad adverse effects. In a capitalized scheme, high levels of savings lead to a good offer for long term capital investments; on the other hand, accumulated reserves might be too large for the size of the economy, leading to an explosion of the real asset’s prices.

It seems very difficult to find sound microeconomics arguments to justify why consumers should be forced to save more than what is enough for the minimum socially acceptable benefit, in the case of fully foreseeable events.

The question here is to define what are socially acceptable benefits for the programmable and no programmable events. Once more, this is only partially a technical question, but a political one. It defines the limits between the basic compulsory Social Security and the voluntary complementary schemes.

10. THE ISSUE OF A SEPARATED WORKMEN’S COMPENSATION INSURANCE VERSUS GENERAL SOCIAL INSURANCE

From the strict standpoint of compensating the worker for the loss of his earning capacity, it is irrelevant whether sickness or disability is related to work or not. Even medical care facilities can be the same for accidents and professional diseases.

From the preventive standpoint it is a whole different story. A separated workmen’s compensation fund, specially if fully financed by employers can, and very often do contribute to better/safer work place environment/practices. Specialized medical facilities, with greater emphasis on accident and trauma, have demonstrated far more effective in the prevention of
lesions than general facilities. Finally, there is a clear need for particular rehabilitation and retraining and replacement services which are better suited within a specialized structure.

In respect to workmen's compensation, there are many lessons to be learnt from the Chilean experience. The Mutualidades were - and still are - in comparative terms, so efficient in administrating the workmen's compensation program that they remained untouched by the reform. In essence, solidary employers of an economic sector pool their resources and mutually insure the work related risks, each firm paying an actuarially calculated tax, as a function of its own risk experience as compared to average sectorial records.

There is, of course, an economic incentive for each entrepreneur to adopt preventive measures as a way of reducing his own costs.

During the last constitutional reform, Brazil went exactly in the opposite direction. By equalizing disability and sickness benefits regardless of their cause, Brazilian legislators had a blindfold view of the problem, illustrating the need of a deep discussion of this type of issue.

11. THE ISSUE OF EARMARKED FUNDS VERSUS THE USE OF GENERAL REVENUES

It is quite frequent to hear, specially from some modernist experts, that Social Security, being universal must be financed by society as a whole. As applied to LASS, Seguridade is a citizenship right and should thus be financed by general government revenues.

This is only partially true. In fact, the universal social assistance schemes, must be financed by general revenues. These programs, destined to relieve extreme hardship, should compete in terms of priority with other government programs. The use of a earmarked fund has no theoretical advantage; in practice, such use of guaranteed resources, with no threat or competition from other programs, tend to perpetuate assistance programs that are no longer needed.

In theory, the financing of a universal basic health system must also be trough general revenues. Political reasons may indicate that the use of some earmarked funds may be a wise policy. Some health programs require continuity of allocation of resources to be effective; this technical characteristic is not always compatible with some variations in the level of
resources according to yearly changing political priorities.

Even when earmarked contributions are used, there is no sense in financing individual health plans according to individual contributions, as it is the case of Isapres in Chile. The health risk is definitely not proportional to one's income/contribution. For that reason, social basic health coverage has to be redistributive. Resources from all contributions must be pooled in a single fund, to be applied according to the needs and priorities of an overall health policy.

Curiously enough, this pooling of resources do not necessarily means a state-owned state-operated health system. Various alternative schemes can be devised and implemented, which can put together the need of a redistribute policy with private enterprise effectiveness.\(^2\)

As for the social insurance component, it is quite clear that it must be financed by earmarked funds. Social insurance must be viewed as a long term contract and, even in a pay-as-you-go system its funds must be preserved from malversion of use. The question here is to preserve the insurance credibility and enhance public cost consciousness and awareness.

The Chilean old-age-retirement scheme is a good example of the clear and exclusive use of earmarked funds, at the individual level, to cost individual benefits. Even when thinking on mutual or collective arrangements, it may be very important to have a clear tie between earmarked contributions and the benefits, as means of giving participants some incentive to control the system.

12. THE ISSUE OF CAPITALIZED VERSUS pay-as-you-go SYSTEMS

Most LASS are mandatory systems, operated by the State (or autonomous governmental agency) based on compulsory contributions and paying cash benefits and/or delivering services on a pay-as-you-go basis. Even when Social Security bureaucrats talk about trust funds and the like, they are usually referring to very small contingency reserves, kept with the purpose of smoothing seasonal fluctuations of income and expenditures. In practice, all contributions are pooled

\(^2\)See, for example, the health-bonus prepaid universal health system proposed for Brazil. A full description of the system can be found in OLIVEIRA and MÉDICI (1991).
in a single fund, with very little capitalization if any. In this type of arrangement current revenues cover current expenditures and, consequently, there is no capital accumulation to pay future benefits or services.

The theoretical discussion on advantages of a pay-as-you-go Social Security system vis-à-vis a capitalized one has been quite long with no definite conclusion. Empirical evidence is very weak on the effects of each system in national savings, product growth etc., even for countries with good statistical records such as the United States.

In the case of IASS, the question is more practical, and, above all, a political one.

In one side capitalized systems do have the potential of increasing social control, if implemented in an individual basis. If the worker, or, more generally the citizen knows that his future benefits will be dependent on his savings account balance, he will be the first to be interested in controlling it. The problem is that the relatively low educated society of most Latin American countries limits severely this potentially efficient control system. The Chilean experience of high turnover of low income/low contribution accounts clearly indicate that this is a real problem, even for that country where literacy rates are far higher compared to the rest of the region.

Collective capitalization schemes, as it is the case of Brazil's Fundo de Garantia por Tempo de Serviço (FGTS), and the newly created mexican supplemental benefit system have less potentiality in terms of social control. In fact, past experience with this type of arrangement indicates that worker motivation is lower.

Another potential threat to capitalized systems is the governmental interference on the use of resources. Specially in countries where capital is scarce and expensive, bureaucrats and politicians view the huge

3 See, for example, SAMUELSON (1958) FELDSTEIN (1974) and BARRO (1978).

4 The FGTS is a collective capitalized fund created in Brazil as a substitute for labour stability. Employers contribute with 8½ tax on payroll and the money is applied by government primary in housing and basic sanitation, earning, theoretically, full inflation plus a very low real interest rate.
sums of capital accumulated as reserves in a fully funded actuarial fund as a good source of money to finance public initiatives. Very often, the public use is limited to the closing of budget deficits, not to mention even worst investments, not compatible with minimum return on capital parameters.

If one looks to the past of LASS, it is very clear to see that bad use of the actuarial reserves was one of the basic causes of transforming most systems from capitalized to pay-as-you-go. The recent experience, such as the Chilean one and the Brazilian Private Pensions, indicates that history may repeat itself: through legislation of minimum applications in the last case or trough political pressure, government can force capitalized funds to buy his own titles. Even the partially funded American system after the reform, is using most of its accumulated reserves in the financing of the Federal Government deficit, arising serious concern among economists and politicians of various tendencis.

On the other hand, pay-as-you-go systems almost completely lacks automatic controls, in the sense of the individual controlling the system. It has to rely very heavily in bureaucratic controls. Once more, experience teaches that in highly informalized Latin American societies these controls tend to be very inefficient, leading to usually high evasion rates.

In the absence of market stimuli for controlling the fund most participants see it more as a governmental tax-service scheme rather than as an insurance.

Due to the aging of populations, bad economical performance, informalization of the work force and growing evasion levels Social Security taxes tend to raise sharply. In turn, higher taxes inhibit economic growth and at the same time give considerable incentive to more informalization and evasion, closing a vicious circle.

If both systems have serious pitfalls, what can be the ideal solution? Although there is not such a thing like an ideal solution in social policy, maybe the closer one can get to a system that works, is by adopting a combination of a basic social security system on a pay-as-you-go basis and a complementary capitalized scheme. In such hybrid arrangement, a basic social security net guarantees minimum benefits leaving to the

5To be used to postpone bankruptcy due to the expected crisis of the beginning of next century.
employers/individuals to complement them with a variety of flexible pension funds.

In practice, even the fully capitalized Chilean scheme sometimes works as a pay-as-you-go system, as government guarantees minimum benefits. If, under certain conditions, there is not enough capital accumulation in the individual account to fund this minimum benefit, government actually transfers resources from the general budget and pays for the difference.

13. THE ISSUE OF CONTRIBUTIONS PAID BY THE EMPLOYER VERSUS PAID BY THE EMPLOYEE

In countries with large informal labor market such as occurs in most of Latin America, this issue has a different meaning. In the informal sector, either employers are invisible to the Social Security authority or they do not exist altogether, in the case of the self-employed and in the case of work done with no monetary remuneration. The question is thus whether the individual shall bear the burden of its contribution for the Social Security or not.

Again, it depends on which component we are talking about. Using the previous discussions, it seems clear that for a number of reasons, social insurance contributions should be preferably paid entirely by the individual himself: it enhances public cost perception and control of the system.

The option for individually paid taxes is less clear as one proceed from the health component to the assistance part of Social Security. If, on one side, the use individually paid contributions may not be the best in terms of social justice, they are sometimes easier to collect, specially when taxes are applied to wages. If this is the preferred option, it has to be made clear to all taxpayers that these contributions for the health system and for social assistance are not for the individual social insurance scheme but for a collective and redistributive fund.

As previously noted, the basic disadvantages of employer paid contributions is that they tend to be passed on to prices, paid by the least capable of paying in an invisible manner that do not favor tax payer cost consciousness.

14. THE ISSUE OF PUBLIC VERSUS PRIVATE

The discussion of privatization is very often held in connection with Social Security reforming in Latin
America. Some reformists say Social Security is inefficient because of its public character, as opposed to the bright performance of the private enterprise and the wonders of the market forces.

As it could be taken from the discussion until this point, it is not at all feasible that a reasonable Social Security system would emerge naturally from the market forces, as a product of profit seeking free enterprise. Theory say and practice confirms that some of governmental intervention is necessary for the creation/maintenance of Social Security systems.

In one sense, the dilemma public versus private is false when concerning social policy in general, and in Social Security discussions in particular. The government role is basically one of promoter of social policies, trough adequate legislation and control. Imposing its taxing powers to collect mandatory contributions and controlling the delivery of cash benefits and services, public authorities simply cannot be substituted in these traditional State functions.

On the other hand, the operation of the various Social Security programs can be successfully carried out by the private enterprise, even in social assistance programs. Specially in Latin America, governmental institutions have a tradition of very low efficiency in Social Security operations; the payment of benefits and the delivery of health social services by public agencies has a long history of bad performance, severely marked by ineffective, bureaucratic and costly programs, not to mention simple corruption.

More than that, the action of government in the operation of the system subtracht from it a basic power: the power to judge. Nobody who is directly involved in one action can be impartial enough to judge this action.

Chile managed, at least in theory, to achieve some kind of equilibrium between public and private actors in its Social Security reforms. At least all the policy making, regulation, supervision and controls are done by governmental agencies, while operations are generally carried out by private enterprise.

Very frequently the political opposition to the privatization of Social Security operations in Latin American countries come from the public servant’s corporations. Feeling endangered, they tend to mix their corporate values and privileges - usually maintenance of their jobs and salary hikes - with the defense of public Social Security systems. Since they are large
groups, it is natural to expect that this type of political resistance might be very strong.

If a substantial reform is a desirable goal, policy makers will have to show voters that public guidance is not incompatible with private operations.

15. THE ISSUE OF EVASION, FRAUD AND CORRUPTION

A significant number of IASS is plagued by tax evasion, fraud and corruption. More than an issue in itself, these factors are consequences of badly conceived and badly operated programs.

Mostly a copy of the German prototype - the Bismarck type of model - does not take into account many particularities of the underdeveloped world. It assumes that, with due enforcement, people will not evade social security taxes nor they will file for undue benefits.

What happens in real world in Latin America is that tax evasion and Social Security benefit frauds are sometimes strategies of survival.

Entrepreneurs sometimes face a very cruel option: bankruptcy or evasion. Since Social Security taxes are high, they rather evade them and, eventually, bribe the Social Security tax collection officers, than paying its costs. In other words, the opportunity costs of evasion and corruption is lower than the cost of paying taxes.

Most government authorities rely heavily on fiscal action to increase revenues. Experience demonstrates that this type of approach tends to be ineffective, specially in Latin America. With very little information at hand, the action of fiscal auditor tends to be costly, time consuming and with very little result. One has to bear in mind that, in most countries of the region, a substantial part of the economy is submerged and invisible to Social Security authorities. For most of this submerged economy there is little or no information available to fiscal auditors, making the task of enforcing the legislation a question of random chance.

In such an environment, policy makers have to perceive that it is necessary to have adequate economic incentives, usually at the individual level, for a

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6Not to mention real underground economy of illegal and criminous activities like drug trafic, illegal gambling etc.
reasonable social control of the systems. Not even a full army of fiscal auditors can substitute the millions of citizens, if adequate incentives are given to them in order to audit Social Security tax collection process. A good start, without going to the Chilean individual contribution and individual savings account, would be simply tying the right to receive Social Security benefits (and services) to the existence of updated contribution records.

It may seem cruel to lay the burden of controlling the system on the workers shoulders, specially by depriving him from the benefit if his Social Security tax has not been effectively collected. From the strictly moral standpoint, it does not really make any sense at all. Unfortunately, we are not dealing with pure moral problems but with the reality of a cruel labor market, an underpaid and bad trained fiscal auditors and very weak information systems.

A second economic incentive to higher collection of Social Security taxes may be the reduction of the costs of the programs and, consequently, the reduction of taxes themselves. Although it is very hard to have empirical evidence, one may suspect that some LASS are on the downward sloping part of the Laffer’s curve.7

Finally there must be some kind of economic disincentive in order to reduce fraud in Social Security benefits. Here, we have a somewhat more difficult problem. It is for certain that if the advantage of a fraudulent benefit is lower, the overall fraud will tend to be also lower. It is just a matter of opportunity cost of receiving illegal benefits versus the potential utility of receiving it.

What happens, specially in Latin America, is that the vast majority of benefits already have low values. Fortunately, in this case, relatively simple administrative solutions are at hand. Modern information data handling techniques, including decentralized systems linked through communication

7In this case the worker would be entitled only to a minimum social assistance benefit.

8The Laffer’s curve relates the level of the tax, as a percent of the tax base, to the percent of the potential maximum tax that is effectively collected. It has the general shape of an inverted U: when the tax is 0%, tax collection is obviously zero; it is also zero, when tax reaches 100% of the base. In other words, when the government takes back everything one earns, either production is zero or evasion is 100%.
networks are well within the technical and economical possibilities of most Latin American countries. These systems could easily control fraud in Social Security benefits, if designed, implemented and managed properly.

In the health area, the need for the correct economic incentives is even greater. The fee-for-service - third payer problem is well known by Social Security and Health Insurance administrators. Costs cannot be controlled if: patient wants the more - and usually the most expensive - services he can get; deliverers of health services want to sell the more - and usually the most expensive - services they can sell; and, at the end, a third part pays the bill, having only bureaucratic controls in order to avoid overspending.

One possible solution to this problem is the prepaid group practice, where profits are made by cost minimization rather than by revenue maximization.

Finally, for the social assistance component, it seems that close community surveillance and control is essential to fraud and corruption reduction.

16. THE ISSUE OF ECONOMIC FEASIBILITY

Most LASS face the threat of bankruptcy, if deep reforms are not urgently undertaken.

First there is the demographic factor. Most Latin American countries have a very young population; the problem is, as shown by Table 2, that the population is rapidly aging. This means that, every other factors held constant, cash benefits and health expenses would tend to grow at a rapid pace.

Second, there is the economic crisis: informal labor markets, low earnings, high evasion, fraud corruption and, above all, exacerbated social needs putting a lot of pressure on the demand for both benefits and services.

Last, but not least, all the political factors mentioned earlier, that make information obscure to the public and the decision process a tortuous one.

Even facing doomsday very frequently, most LASS have managed to survive. Of course there is a price to be paid. Some systems used a variety of tricks, ranging from below cost-of-living indexing of benefits paid to simple raises in taxes.
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Source: International Labour Office.
As bad as they can look to the eyes of Social Security experts and other technical people, these measures have been very effective in reaching their real political goal: to postpone doomsday.

17. THE POLITICAL PARADOX

Along all this paper, the political factor was very often invoked. Let's now look closer to this fundamental element for Social Security reforming in Latin American.

Most politicians of most countries recognize the need for deep reforms in the Social Security programs. Very few would, in fact, take any positive steps towards a reform.

Their attitude is far from irrational. Social Security reforms have indeed a very negative political aspect: potential gains occur over a long time span, and usually grow as time goes on; political losses are immediate, and usually very large in the beginning, eventually decreasing in time. In other words, politicians are faced with a trade-off they very seldom accept: the loss of present day political support in order to get eventual long range recognition of their merits.

As a matter of fact, specially in the social insurance component, it is possible to shift the cost of the adjustment to future generations, that in some cases, have not yet been born.

If this is the case in most developed countries, one can easily imagine the problems in developing countries of Latin America. Using the taxpayer ignorance, some politicians shift the responsibility to the Federal Government, to the recession etc. Public opinion is diverted from solving the problem to the secondary questions of finding the guilty actors.

Nevertheless, its obvious that the need for Social Security is quite urgent in most of the countries in Latin America.

18. STEPS TOWARDS REFORMING SOCIAL SECURITY

Unfortunately, there is no very way to reform Social Security in a democratic environment, such as the one enjoyed by most Latin American countries in present days. In the opinion of the author of this paper, if there is a single recommendation that could apply to most countries, it would necessarily include five basic elements:
- information to the public in all possible aspects of the existing system and on all alternative proposals;

- consistency of proposals, in terms of well structured conceptual framework of programs and their respective funding; it is also important that Social Security reforms be not an isolated item, but an integrated and consistent part of the overall development project;

- respect of acquired rights during the transition, in order to minimize political resistance of organized groups;

- economic incentives for the change and social control of the systems, relying on the citizen rather than on the bureaucrat as the basis of social control;

- public participation, in terms of making conflicts of interests clear and give voice (and vote) to the marginal majorities of Latin American societies. The real challenge is not to have Social Security systems that cover the formal sector in a better way; it is to reduce inequality, bringing the marginal people under coverage of better systems.

Finally, there is an element for Social Security reforming in Latin America that was not mentioned until now: time. Time is needed until our societies learn how to practice democracy; time until the right information can get to the right people; time until never social values can permeate all the society, reducing inequality and promoting a more socially balanced development process. Only then, Social Security reforms will leave the theoretical sphere and get into political reality.
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