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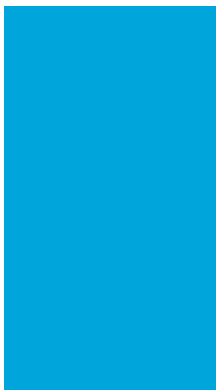
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Center for Latin American Studies  
University of California, Berkeley



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Insurance Scheme Serve as a Model for  
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December 2004

Paper No. 12

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## 1. INTRODUCTION

In October 2002 the Chilean government implemented new legislation for an unemployment insurance program which it claimed was the first genuine alternative to traditional systems of unemployment benefit and assistance.<sup>1</sup> The program provides unemployment insurance based on each worker's individual level of savings accumulated in a personal unemployment account in the same way that a private pension system would pay pensions according to the level of savings accumulated during a person's working life. Contributions to these personal savings accounts are made by both employers and individual workers, and the government provides a contingency fund from which a worker can draw under certain conditions should individual funds be insufficient. It is the mechanisms through which this contingency fund is combined in one single institutional structure with individual savings accounts that makes this system innovative.

The Chilean unemployment insurance has been presented both at a national and international level as a model for other developing countries, as it provides protection against unemployment but has a relatively low public finance requirement. The insurance program was also specifically designed to avoid issues of moral hazard associated with traditional unemployment insurance systems, which would unduly stress the limited financial resources of a developing country.

Thus, the ILO has described the Chilean unemployment insurance as a "new legislation that could lead to a new generation of reforms in unemployment insurance matters" (Panorama Laboral 2001: 50). Given how frequently Chile is touted as a 'model' for other Latin American and developing countries, this innovative program is likely to be copied elsewhere, as it constitutes an example of how a developing country can address the issue of unemployment, even if it does not dispose of the same level of resources for social benefits as high income countries do. The Chilean government is already advising other Latin American countries on setting up their own unemployment insurance based on its model.<sup>2</sup>

So before this unemployment insurance program is copied by other developing countries,



and perhaps also by developed ones, we should ask whether it really does provide adequate insurance for the unemployed. Initial research conducted on the Chilean case based on a survey specifically designed to assess how the program will work in practice, suggests that wage-earners in the formal sector with good quality jobs will be those best covered by this insurance program, whereas wage-earners with short-term contracts, or without formal written contracts (i.e. precarious and low income jobs) will hardly be covered by the system at all. Since workers with low quality jobs seem to face a far higher probability of becoming unemployed, this means that the vast majority of the unemployed will not benefit from this insurance system.<sup>3</sup>

This paper is the first published account of how this unemployment insurance will work in practice based on an employment survey conducted with this purpose specifically in mind. The paper first examines the new Chilean unemployment insurance in the context of Latin American labor market legislation and concerns, which is necessary to understanding its particular design. It then explains the mechanisms of the system and describes how it will work in practice, before going on to examine empirical evidence and assessing the extent to which the program will cover the unemployed in Chile. The paper concludes by examining whether the unemployment insurance program can serve as a model for other developing countries.

## 2. THE HISTORICAL AND POLITICAL CONTEXT OF UNEMPLOYMENT INSURANCE IN LATIN AMERICA AND CHILE

Every unemployment insurance program is designed according to the particular historical and political conditions specific to its country of origin, which often determine its benefits and limitations. In order to understand why the new Chilean unemployment insurance was designed in its very particular way, we need to examine the principle factors that influenced this design. Based on documents and discussion papers published on the new unemployment insurance in Chile, four such factors can be distinguished: first, the existing structure of its labor code and the particular characteristics of Latin American labor markets. Second, the example of other systems of unemployment insurance in the region. Third, the theoretical debates on the design of

unemployment insurance. And fourth, the specific political context of labor market legislation in Chile.<sup>4</sup> This section will examine each of these factors in turn.

## 2.1 LATIN AMERICAN LABOR CODES AND LABOR MARKETS

Historically, most Latin American countries have lacked the resources to provide comprehensive unemployment insurance for their workers.<sup>5</sup> However, the region has always been and still is subject to repeated macroeconomic shocks, which can cause severe unemployment. In order to provide workers with some form of protection during potential spells of unemployment, labor market legislation in Latin America strictly regulates procedures for dismissals and redundancies. This legislation generally consists of three components: advance notice requirements, a distinction between what is termed ‘just’ and ‘unjust’ dismissals, and severance payments. In addition to these legislative requirements, Latin American governments also often resort to employment generation programs in order to control unemployment. We also need to take into account the role of the informal economy in the context of controlling the unemployment rate and providing resources for the unemployed. This section discusses each of these issues in turn, beginning with legislative requirements.

Employers in Latin America are first of all required to give their employees notice before making them redundant or dismissing them. In most cases, the period of advance notice required is one month. Should an employer wish to dismiss an employee immediately, they are required to pay the worker a compensation equivalent to the salary he or she would have earned during the period of notice.<sup>6</sup> Second, Latin American Labor Codes generally distinguish between ‘just’ or ‘unjust’ causes for loss of employment. ‘Just’ causes include reasons attributable to the worker (e.g. some form of misconduct), voluntary resignation, and expiration of contract. ‘Unjust’ causes for dismissal refers to economic reasons (translated from the Spanish *necesidad de la empresa*,) and mainly includes downsizing and firm closures. This distinction is crucial in the context of unemployment insurance because different reasons for unemployment lead to different levels of benefit and compensation for the worker.

Workers who are made redundant for economic or ‘unjust’ reasons are generally entitled to some form of severance pay from their employers. Originally, severance pay was instituted to provide job security by imposing a penalty on employers if they rotated workers and to provide workers with income during their period of unemployment. The compensation to which the worker is entitled typically consists of one month’s wage per year of tenure (or a proportion or multiple thereof). Some countries impose maximum limits on severance pay entitlements.<sup>7</sup> In Chile, for example, this limit is 11 months of wages, which is equivalent to 11 years of tenure.

Experts agree that redundancy costs in Latin America are much higher than in more developed countries.<sup>8</sup> As a result, severance pay legislation has come under attack from some analysts who claim that it introduces rigidities into the labor market, by imposing potentially high lay-off costs on employers. The arrangement is therefore countercyclical for employers and considered an obstacle to the flexible labor market legislation required to lower unemployment rates.<sup>9</sup>

In practice, however, employers often avoid paying the full amounts of severance pay due, by coming to agreements with workers who are generally obliged to accept whatever terms the employer offers.<sup>10</sup> In this survey, only 44 percent of the unemployed dismissed for economic reasons claimed that they had received some form of compensation. Among the unemployed who should have received a payment but did not, 22 percent said that they had reached an agreement with their employer, while 44 percent stated that the employer had simply refused to pay. These figures show that we should treat any study claiming that severance payment regulation introduces rigidities into the market with a degree of skepticism, unless it specifically measures the degree of compliance with this legislation and limits its analysis to formal employment.<sup>11</sup>

However, it is important to note that the *de jure* stipulations of the severance pay system only provide protection against unemployment in the measure that the number of years an unemployed person spent in their previous job is at least equal to the number of months they are unemployed. Consequently, workers with long periods of tenure are adequately covered by such

a system, while workers with short periods of tenure may find that their severance payments are inadequate to cover their living expenses during periods of unemployment. This means that in Latin America the payments received for periods of unemployment have always been correlated with the time spent in the previous job.

Whatever the rate of compliance or the effectiveness of severance pay legislation in Latin America may be, it is the most important component of the regulation protecting workers against unemployment as it sets the standard against which all other forms of unemployment insurance are compared.

Another measure of ‘unemployment insurance’ that Latin American governments — whatever their political persuasion — have historically resorted to in times of economic downturns or crises, is employment programs. These are designed to keep official unemployment rates below ‘reasonable’ levels, and in times of economic crisis are very necessary to keep people from falling below poverty lines.<sup>12</sup> The recent employment crisis in Chile, for example, was no exception, and analysts estimate that the 1999 employment program shaved almost 1 percent off the official unemployment rate.<sup>13</sup> A wide range of such policies were also used in Argentina to tide people through its most recent economic crisis.<sup>14</sup> Such employment programs are necessary, in part, because there is very little effective insurance against unemployment in Latin America, as we will see in the following section.

Despite the existence of these employment generation programs, fiscal expenditure on labor market policies in the region is very low. OECD countries, for example, spend an average of 2.06 percent of their budget on labor market programs (with a range from 4.85 percent in Finland to 0.43 percent in the United States), while the Latin American expenditure ranges from 0.94 percent in Jamaica to 0.03 percent in Chile.<sup>15</sup> These figures combine expenditures on unemployment compensation, employment generation and training for the unemployed. This low level of expenditure indicates that the effective coverage of any unemployment insurance program is likely to be quite low.

Another peculiarity of Latin American labor markets that has to be taken into account in this study is the existence of large informal sectors in these countries. Using the ILO's definition of the term informal sector, which comprises the self-employed, workers from microenterprises (less than five employees), nonremunerated working family members and domestic employees, we can see that the informal sector in Latin America employed 46.5 percent of the labor force on average in 2002.<sup>16</sup> Many analysts claim that the rigid legislation prevalent in Latin American labor markets generates these large informal sectors.<sup>17</sup>

The existence of such extensive informal economies in Latin America is important to bear in mind for two reasons: first, labor market legislation in the region generally only regulates formal employment. So legislation regarding redundancy requirements, especially severance payments, but also other forms of unemployment insurance, is not applicable to informal employment. As we will see in the course of this paper, this point has very important implications in terms of the coverage of any insurance program. Second, the existence of the informal sector provides employment opportunities for the unemployed. Unfortunately, there is no conclusive evidence so far on the extent to which the informal sector 'absorbs' excess labor from the formal sector in times of economic downturns. We can be sure, however, that the two are related, and that a proportion of informal employment is actually disguised unemployment. This means that, to an unknown degree, the informal sector acts as unemployment insurance.

## 2.2. UNEMPLOYMENT INSURANCE IN THE REGION

In the development processes of the Latin American countries, unemployment insurance is generally the last type of social security insurance that they implemented, if indeed they implemented any at all.<sup>18</sup> Broadly speaking, two types of unemployment insurance currently exist in Latin America: traditional unemployment assistance<sup>19</sup> and personal savings accounts. We will discuss each of these in turn.

Some form of unemployment assistance program exists in Argentina, Barbados, Brazil, Chile, Ecuador, Mexico, Uruguay and Venezuela.<sup>20</sup> In most of these cases, the relevant legislation

was instituted in the 1980s. The replacement rates of these insurance programs vary, but generally represent between 40 and 60 percent of a worker's former wage. However, minimum and maximum levels are applied, which are generally expressed in proportions and multiples of the respective minimum wages. Some of these insurance programs are entirely government financed (Mexico and Uruguay, for example) and others are financed by a combination of employer and worker contributions.<sup>21</sup> What all these unemployment insurance programs have in common, however, is that their coverage is so low that only a very small proportion of the unemployed actually receive a subsidy. Jaramillo and Saavedra state that "empirical evidence suggests that in practice these programs have a very limited impact on the unemployed" (Jaramillo and Saavedra, 2004: 22). They quote coverage rates of 7.4 percent of the unemployed in Argentina, 11.8 in Brazil and 16 percent in Uruguay. And in Chile the coverage rate has also always been very low, generally below 15 percent. Coverage is partly so low because the monetary value of benefits is inadequate.

These unemployment assistance programs therefore cannot be regarded as a social safety net for the poor in times of economic crisis. First, because of the above mentioned low coverage rates, second, because their benefits are generally not means tested and third because they only cover the best quality jobs in the formal sector, i.e. employees who had open-ended contracts with all the associated social security benefits that this implies. For these reasons the unemployment insurance programs in the region are highly inequitable.

Due to these problems, some countries have implemented individual savings accounts as an alternative type of insurance or as an additional mechanism of protection against unemployment. These personal savings accounts originate from the idea that since severance pay legislation is countercyclical, has low rates of compliance and introduces rigidities into the labor market, it would be better to pay a proportion of future severance payments into individual savings accounts while workers are working as a provision against potential redundancies. In the eventuality of becoming unemployed, workers can then draw on these accounts and are thus

protected against unemployment. The main advantage of these programs is that they avoid issues of moral hazard as workers are basically drawing on their own funds.

Such legislation exists in Argentina (for construction workers only), Brazil, Chile (the new program), Colombia, Ecuador, Panama, Peru and Venezuela. Conditions for these programs vary significantly from country to country in terms of the structure and amount of mandated contributions, the conditions under which claims can be made, the extent of benefits, and their institutional characteristics.<sup>22</sup> The oldest such system in Latin America, the Fundo de Garantia do Tempo de Serviço (FGTS), was originally instituted in Brazil in 1966. In Brazil employers contribute 8 percent of their payroll to an individual account for each worker. If they then dismiss the worker for ‘unjust’ causes, he or she can withdraw these funds and is entitled to an additional payment of 40 percent of the accumulated amount as severance pay. There is no connection between the Brazilian unemployment assistance and the FGTS, so that any payouts received from the FGTS are independent of the receipt of other benefits.<sup>23</sup>

In countries where both unemployment assistance and individual savings accounts exist, they afford a double protection for wage-earners with formal contracts, while excluding the self-employed and all workers who do not have formal written contracts. Workers with short-term contracts are protected to a very limited extent by some of the individual savings account programs. It is thus clear that wage-earners with the best quality jobs are the most protected, while workers with the worst quality jobs are the least protected by these programs.

Another criticism often made of the Latin American unemployment insurance systems and individual savings accounts described above is that they are not sufficiently connected to other labor market institutions, such as job centers and professional training institutions. This ties in with another problem associated with any type of unemployment insurance in the region, which is that the institutional infrastructure required to adequately monitor the unemployed and to help them find new jobs is not available. This is partly why it is so difficult to implement effective traditional unemployment insurance in the region, which can control issues of moral hazard and abuse by means testing claimants and monitoring their efforts to find new employment.

### 2.3. THEORETICAL DEBATES ON UNEMPLOYMENT INSURANCE IN CHILE

Most papers written by Chilean analysts about unemployment insurance begin with a discussion of two theoretical concerns associated with traditional unemployment insurance: first, the fact that due to adverse selection criteria unemployment insurance is not an insurance provided by insurance companies in a free market. Second, they argue that traditional unemployment insurance programs are subject to abuse (moral hazard) and that any new Chilean unemployment insurance program must therefore avoid such risks.<sup>24</sup> It is important to discuss this body of literature here as it illustrates which theoretical concerns influenced the design of this new insurance.

The idea that unemployment insurance is not provided by free markets of their own volition is borne out by the practical evidence of the voluntary unemployment insurance program, the Pacto de Indemnización Sustitutiva, that existed in Chile prior to the new obligatory program. This program allowed employers and employees to contribute half a month's salary per year of service from the seventh year of employment onwards to an unemployment insurance fund, withdrawable in any circumstances of loss of employment including resignation.<sup>25</sup> Although the benefit could have been offered by employers as a nonmonetary incentive to employees, only negligible use was made of this option.<sup>26</sup>

This argument is often included in articles analyzing unemployment insurance in Chile in order to show that unemployment insurance constitutes one of the areas in which the state has a legitimate responsibility to regulate since the free market would not naturally provide such insurance. The argument is also designed to pacify neoliberal critics who are opposed to unemployment insurance as a matter of principle based on their view that the state should not meddle in market mechanisms.

The second argument that analysts almost always discuss in the context of unemployment insurance in Chile is even more important to understanding the particular design of the new insurance program. It relates to the risk of any unemployment insurance being open to risk



of abuse by the unemployed, a risk that is commonly referred to as ‘moral hazard.’ The unemployed could for example claim insurance benefits even if they are working. This is a particularly common problem in a developing country with a large informal sector, as workers can easily work informally while at the same time claiming benefits. There is also concern that the existence of unemployment insurance will lead to longer durations of unemployment and to higher unemployment rates, as the unemployed take longer to find themselves new employment, or become choosier as to which job they accept. These risks are compounded by the fact that developing countries generally do not have the institutional capacity to monitor the behavior of the unemployed, e.g. whether they are making a genuine effort to find new work or whether they are working informally.

The main argument that Chilean analysts present in favor of unemployment insurance in the literature is that it will make the labor market more flexible and run more smoothly, thus benefiting both employers and employees. This argument is not only based on evidence that unemployment insurance potentially increases the efficiency and productivity of labor markets by matching workers and their skills better with the new jobs they find, but also on studies that argue that the severance pay legislation introduces significant rigidities into a labor market, as was discussed in the previous section. The argument *for* unemployment insurance is thus largely based on the argument *against* the rigidities of the existing severance pay system in Chile.<sup>27</sup>

This argument combined with the discussion of moral hazard means that theoretical papers that propose a program based on individual savings accounts have had much resonance in Chile.<sup>28</sup> One such paper by Altman and Feldstein, for example, is quoted in almost all the Chilean literature. Their article is based on the view that unemployment insurance increases both the number of unemployment spells (and therefore the unemployment rate) as well as the duration of unemployment. The paper runs through a model of an unemployment insurance based on private accounts into which 4 percent of the wage is paid as a personal saving. Should the accumulated amount not be enough to finance a maximum period of six months unemployment, workers can obtain a loan from the government in order to cover the deficit. Balances in personal savings

accounts can therefore be both negative and positive. The idea is that individuals fully internalize the cost of unemployment compensation in order to avoid all issues of moral hazard related to traditional unemployment insurance programs.

The authors use the U.S. Panel Study on Income Dynamics to test the model over a period of 25 years (1967-91), and conclude first, that almost all workers will have positive balances in their savings accounts at the end of their working lives, and second, that the cost of forgiving negative balances in personal savings accounts at the end of a working life would be less than half the cost of current unemployment insurance.

While these theoretical debates can be very enlightening and help policy makers achieve the right policy mix, it is important to bear in mind that in a developing country such as Chile the reality of the labor market may be very different, so that these models and theories cannot simply be applied to their situation without adjustments.

First, evidence and theories from an industrialized, developed country do not take account of the huge informal sectors that operate in the developing labor markets, and which operate according to their own rules and, to an unknown extent, absorb surplus labor force.

Second, theoretical legislation in a developing country may not always have the practical implications that one would assume given the limited compliance with and enforceability of laws. This point is often ignored by analysts because very little data is available on compliance with labor legislation (e.g. only this survey provides an estimate of what proportion of due severance pay in Chile is actually paid out).

Third, as discussed above, a developing country's resources are much smaller, so that the available benefits are very minimal as is their coverage. This makes most of the moral hazard arguments inapplicable to the cases of developing countries. Fourth, the debate about the effects of unemployment insurance is still relatively inconclusive as there is much contradictory evidence (eg. Spiezza, 2000). And fifth, there is the problem that in a country like Chile, there is no available data with which a model such as the one proposed by Altman and Feldstein could be simulated and tested.

#### 2.4 THE POLITICAL CONTEXT OF LABOR MARKET LEGISLATION IN CHILE

The empirical evidence from other countries and the theoretical points of view discussed above have undoubtedly influenced thinking about unemployment insurance in Chile. The latter are important, not because they reflect empirical realities in Chile, but because the social actors believe them. For the Chilean government avoiding the risks of ‘moral hazard’ was a primary concern when the new insurance proposal was designed in order to make it a politically viable project. This section will examine the political context of this unemployment insurance, in particular the positions of the main social actors: employers, workers and the government.

The main concern of Chilean employers is labor market flexibility, and the most important obstacle to this is severance pay legislation. As we saw above, the argument *for* unemployment insurance in Chile is largely an argument *against* the inflexibility that severance pay legislation imposes on employers. For employers, therefore, the perfect solution would be to replace severance pay with some form of unemployment insurance, provided this would not represent an additional cost to them.<sup>29</sup>

To workers, represented in any discussion on labor market legislation by the unions, severance payments are regarded as the hard won gains of decades of labor disputes. Saavedra and Jaramillo refer these gains as ‘*derechos adquiridos*’ or acquired rights. Unions across Latin America are extremely resistant to the erosion of these rights, which has been repeatedly attempted by recent labor reforms in Latin America. The idea of replacing severance payment legislation with more comprehensive unemployment insurance (based on the model of developed countries) has therefore been fiercely opposed by Latin American unions as this would mean giving up hard won historical entitlements.

However, as discussed above, severance pay legislation is often not complied with, and its practical impact is also decreasing as job tenures shorten in Latin America.<sup>30</sup> The importance of severance payments to both employers and unions is therefore more symbolic than practical, especially in Chile where these entitlements were gradually built up during the 20<sup>th</sup> century, then

abruptly eroded during the Pinochet administration in the 1970s and partially restored under the first democratic government in 1990.

The Chilean government therefore finds itself in a position where it constantly has to reconcile these conflicting, ideologically charged and historically sensitive positions. President Lagos invested a significant amount of political capital during his election campaign, which fell into a period of rising unemployment rates, into the promise that he would institute an unemployment insurance program in Chile. He summarized his view during the campaign by saying that:

“How is it possible that Chile today still has no [unemployment insurance], how is it possible that faced with a crisis... the increase in unemployment simply means hunger and privation for many, because we haven’t been able to agree on a formula for an unemployment insurance<sup>31</sup>. This is unacceptable.... My government will legislate on unemployment insurance, learning from the mistakes made in other countries. We will turn this into an indispensable element for creating more social justice for the Chilean working class. So that it does not feel that it is dealt the worst blow when a crisis strikes.”<sup>32</sup>

Running on an electoral platform committed to growth with equity and social justice, it is not surprising that Lagos promised unemployment insurance. In this quotation, President Lagos is trying to reassure the political left by promising more social justice and better protection for the working class, as the left fears that an unemployment insurance program based on personal savings will impose extra costs on workers without really providing them with sufficient income security.

However, faced with significant opposition from employers and the political right who fear that any unemployment insurance would increase the unemployment rate, while increasing government expenditure on the unemployed, Lagos promises “We will learn from the mistakes made in other countries.” Here, he is attempting to appease those whose views are summed up by comments such as: “Traditional unemployment insurance systems have failed in Europe,

due to the high level of infiltration and abuse.<sup>33</sup> Lagos's comment is targeted at employers who fear that an unemployment insurance program will impose higher labor costs while increasing unemployment rates and durations.

Given that the Chilean government had to reconcile these conflicting positions of employers and unions, the new unemployment insurance program must be regarded as a compromise solution, as we will see in the following section.

Before examining the details of the insurance program, however, we must bear in mind one more relevant issue in the analysis of the political context of this unemployment insurance program, which is that the political and technical debate in Chile has been largely influenced by political and historical bias because there is a lack of objective data.

The inadequacy of the existing data leaves too much room for biased interpretation and speculation that is not strictly based on facts. And what little data does exist, is rarely referred to in the studies or debates on the unemployment insurance program.<sup>34</sup> Information gathered by the standard official surveys on unemployment is limited to the most basic characteristics of the unemployed: their sex, age, level of education, and the length of time that they have been looking for work.<sup>35</sup>

Three main aspects have thus been ignored that are very important features of unemployment: first and foremost, what sort of jobs did the unemployed hold before losing their work? (i.e. what types of jobs are most likely to lead to unemployment?). Second, what are the patterns of labor market mobility (i.e. how do people move between states of inactivity, informal employment, formal employment and unemployment)? And third, if an unemployment insurance program is to be designed, which characteristics of the unemployed need to be taken into account in designing insurance that protects different groups of workers? While Chilean government officials had partial information with which they could estimate some of these factors, their information was far from complete and did not come from a coherent source. During the ten years that this legislation was discussed by the Chilean government, not a single survey was

carried out that would provide the necessary information, especially on the characteristics of the previous jobs of the unemployed.

The survey that this paper is based on was specifically designed to address these issues. As already described, it included a specific questionnaire for the unemployed, in which they not only answered questions related to their current situation and job search, but also concerning their previous jobs held. This enables us to compare the characteristics of the jobs held by the unemployed with those of the employed. The main purposes of this comparison are twofold: on the one hand, it allows us to draw conclusions about which sorts of jobs are the most vulnerable. And on the other hand, given the design of the unemployment insurance proposal, it allows us to examine to what extent the unemployed will actually be protected by this insurance, as this analysis requires data on the previous job held as well as on their current situation, *i.e. it depends on a combination of information that no Chilean survey so far had gathered*.<sup>36</sup> This paper will therefore assess whether in future Chilean workers will indeed be protected against the misfortune of unemployment, as Ricardo Lagos promised in his election campaign.

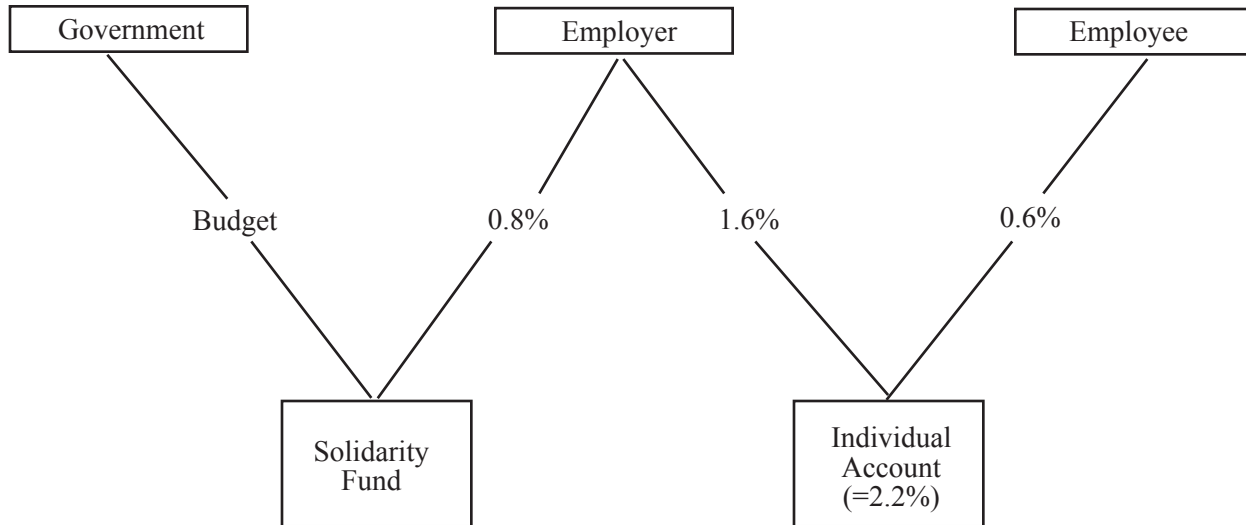
### 3. THE UNEMPLOYMENT INSURANCE SYSTEM IN CHILE

In this section we will see how each of the concerns discussed in the previous section influenced the design of the Chilean unemployment insurance. The insurance is a mixed program, financed by all social actors (government, employers and employees), and it creates two types of funding mechanisms: an individual savings account for each worker and a contingency fund, called ‘Solidarity Fund.’ If the accumulated savings in the individual’s account are insufficient, he or she acquires the right to receive a subsidy from the Solidarity Fund — under certain conditions and restrictions, of course.<sup>37</sup>

The government has committed itself to spending an amount from its annual budget on the fund equivalent to its expenditure on the unemployment subsidy that existed before this new insurance was introduced. The employer is to pay another 0.8 percent of each employee’s monthly wage into this fund. In addition, the employer pays 1.6 percent of wages into an individual account set up for each employee (similar to a pension account), to which the worker contributes 0.6 percent of her monthly wage. This amounts to a total of 2.2 percent of each

monthly wage being paid into the individual accounts, *which over the course of a year will accumulate to an amount equivalent of a quarter of the worker's monthly wage*. This percentage complies with the desire of employers to institute unemployment insurance at the lowest possible additional cost to them.<sup>38</sup>

**Figure 1**  
**Structure of the Unemployment Insurance**



These conditions described so far apply to all wage-earners in the labor force,<sup>39</sup> regardless of their type of contract (but provided they have a contract), and regardless of the circumstances under which they become unemployed. In addition, workers with open-ended contracts who are dismissed for unjust reasons have the right to severance payments designed to top up their funds to the limit of current legislation (one month's salary per year of employment with a maximum limit of 11 years). This complies with the condition of unions that the new unemployment insurance would not leave workers worse off than under the previous legislation. This means that the employer has to make up the difference between the funds already contributed to the individual account and existing severance pay arrangements, so that in theory employees do not lose out relative to their current position under any circumstances. The only additional cost of the program to employers is therefore the contribution they make towards the Solidarity Fund.

Slightly different conditions apply to workers who have fixed term contracts. In their case,

the employer must pay 3 percent of their monthly wage into their individual savings accounts during the duration of their contract, and they are not entitled to any severance pay.

To withdraw funds from this insurance program the worker must have contributed (not necessarily continuously) for 12 months prior to becoming unemployed,<sup>40</sup> must be aged between 18-65 years, and have been unemployed for at least 30 days. The latter condition means that the unemployed have to finance the first month of unemployment themselves. This condition is similar to a deductible that most insurance policies require their clients to pay.<sup>41</sup> The structure of the insurance is based on a calculation that the average duration of unemployment (during periods of normal economic development in Chile) is approximately five months. Hence the number of withdrawals that can be made from the individual accounts is five, regardless of the amount accumulated in the account. Only workers with fixed term contracts have the right to access their entire savings in one single withdrawal.

Unemployed persons dismissed for unjust reasons, who have accumulated less than two month's wages in their account, are entitled to top up funds from the Solidarity Fund. The amount and number of withdrawals that can be made are calculated according to a specified method (see the table in the Appendix). On the other hand, if more than two month's wages have been accumulated in the account, the total sum, regardless of its amount, is divided by five and paid out in monthly installments. It is the inclusion of this Solidarity Fund which differentiates this insurance program from other existing ones in Latin America and the rest of the world.

The Fund replaces the unemployment insurance assistance that operated prior to the introduction of this program, which paid benefits for a longer period of time (12 months), but only such small amounts that the coverage of the program was almost negligible.

If the individual changes jobs without a period of unemployment between them, the clock is reset, and the individual is free to either withdraw accumulated funds or to leave them in the account, without this having any impact on the payment obligations of his new employer.



Beneficiaries from the unemployment insurance will also be registered at municipal employment agencies by the administrating body of this insurance. This means that they will automatically be registered with employment mediation services. Unemployed workers benefiting from the program and dismissed for business reasons will have a preferential right of access to professional training programs offered by the National Training Office.

To sum up, the following characteristics of the worker and his previous employment determine whether and to what extent the worker is covered:

- Type of contract held in previous job (open-ended or fixed term);
- Previous level of income;
- Minimum duration of previous job: one year (to be able to contribute for 12 months) or half the time in the case of workers with fixed term contracts;
- Length of employment duration (determines amount accumulated in the account);
- Reason for unemployment (just or unjust reasons);
- Age of the worker (18-65);
- Minimum duration of unemployment: one month (to be able to withdraw funds).

These conditions mean that all self-employed and fee paid workers (*honorarios*), employers and wage-earners without a written contract as are excluded from this insurance program, as are workers under the age of 18, and over the age of 65. Fixed-term workers are barely covered by the program, and contributors who have not worked for at least 12 months (six months in the case of fixed term contracts) or who have been unemployed for at least 30 days do not have the right to withdraw any funds at all. In addition, the amount of funds that the worker is entitled to depends on the reasons for his unemployment. It is these conditions that we need to bear in mind when analyzing the data relevant to the unemployed.

#### 4. EMPIRICAL ANALYSIS OF THE UNEMPLOYMENT INSURANCE

This section will analyze empirical evidence related to the variables discussed above which determine the benefits that workers will receive from this insurance. The data discussed below relates to both the employed and the unemployed and compares the characteristics of the jobs of the former with the previous jobs of the latter. This is to say that it compares how the employment situations of those people who end up becoming unemployed compare to the employment situations of workers who do not become unemployed. To the author's knowledge, this is the first time such data has been presented on the Chilean labor market. As we will see in the course of this section, the jobs the unemployed held were of a significantly inferior quality than those of workers in employment. This means that more precarious jobs are more likely to lead to a situation of unemployment.

This discussion is limited, however, to the unemployed as they are generally defined by employment surveys, i.e. a worker had to be actively looking for work and not be engaged in any remunerative activity at all, no matter how minor, in order to be considered unemployed.<sup>42</sup> Workers who lost their jobs and switched into the informal sector are not included in this data. In practice, they would, however, form part of the group of potential beneficiaries from the unemployment insurance as its criteria are based on job loss as opposed to any particular definition of unemployment. This means that it is perfectly possible to claim unemployment insurance payments while informally working.

The most important variable that we must consider first of all is the employment status of a worker, i.e. whether they are wage-earners or self-employed. And if they are wage-earners, we must consider what type of contract they had in their previous job. As Table 1 below shows, over 95 percent of the unemployed are from the dependent categories of the work force, i.e. blue and white collar workers and domestic service, reflecting the fact that unemployment rarely occurs as a visible phenomenon within the independent sector. This compares with 77 percent of the work

force in general. This shows that the self-employed absorb an economic crisis more through lower incomes rather than loss of jobs as a result of the cessation of business.

In the wage-earning sector, an important discrepancy between the characteristics of the unemployed and the employed is related to the type of contract. The proportion of unemployed who previously had some form of an atypical contract or no contract at all is significantly higher than the proportion of these contracts among the total work force. The percentages listed in the 'Ratio' column illustrate this phenomenon. Only one third of the unemployed had open-ended contracts in their last jobs, as opposed to 67 percent of the wage-earning work force.

**Table 1**  
**Distribution of the Employed and Unemployed**  
**by Type of Contract and Level of Formality**

		Employed		Unemployed		Ratio
		Percent Subtotal	Percent Total	Percent Subtotal	Percent Total	Percent
Waged Workers	Open-ended Contracts	65.7	50.6	33.3	31.7	10.2
	Total Atypical Contracts (1+2+3)	15.6	12.0	31.6	30.1	31.3
	Fixed Term (1)	10.3	7.9	16.7	15.8	26.6
	Project/Service (2)	2.2	1.7	6.3	6.0	39.3
	Honorario (3)	3.1	2.4	8.6	8.2	38.5
	No Contract	18.7	14.4	35.1	33.3	29.6
	Subtotal Waged Workers	100.0	77.0	100.0	95.1	18.3
Independent Workers	Employers/Prof. Self-Employed	17.7	4.1	22.2	1.1	4.7
	Self-Employed	82.3	18.9	77.8	3.8	3.5
	Subtotal Independent	100.0	23.0	100.0	4.9	3.7
Total			100.0		100.0	

*Note: Excluding all cases who did not know what type of contract they have or had. The ratio is calculated based on the interviews and information received, not on the basis of the entire sample, as follows:  $\frac{\text{Unemployed} * 100}{(\text{Employed} + \text{Unemployed})}$ .*

The reasons for this discrepancy are relatively obvious: it is in the nature of fixed term contracts that they terminate at some point, and that the worker then has to find a new job, generally passing through a spell of unemployment in the between time. This is an important

issue that any unemployment insurance program should address, and we will return to this point when discussing the program in the next section.

As regards wage-earners without a formal contract, their rate of unemployment is similar to that of wage-earners with atypical contracts. As we saw in the previous section, these workers are excluded from the insurance program a priori because they did not have formal contracts.

The next variable we must consider is the duration of unemployment so that we can determine whether the unemployed would be adequately covered by the five withdrawals they can make from their individual savings accounts. However, in order to capture the significance of the unemployed who find jobs within a very short period of time the following table presents two different calculations of the unemployed: the ‘current unemployed’ (i.e. those who were unemployed at the time when the survey was undertaken) and the ‘recent unemployed’, who are those workers who were unemployed at any point during the last year.

Table 2 shows that a high proportion of the ‘recent unemployed’ find a new job within one month: 22 percent. The significance of this number would not be captured if we considered only the ‘current unemployed.’ It is important to highlight this fact, because as we saw above, these individuals are excluded from the unemployment insurance program. While they would have their last salary to live on during their first month of unemployment, they have no income for their first month in their new jobs.

The data confirms that the majority of the unemployed (72 percent) find a new job within six months, during which time they would be covered by the five installments that the unemployment insurance pays, either through their accumulated savings or from payments from the Solidarity Fund should these savings be insufficient. Slightly fewer than 30 percent of the unemployed would not be covered for the entire duration of their unemployment, 13 percent of whom must be considered long term unemployed. Table 2 shows that the average duration

of unemployment fits well into the six month period of coverage, if we exclude the long term unemployed<sup>43</sup>. It should also be added that these figures refer to a time of unemployment crisis, during which one would normally assume a longer duration of unemployment than during periods of normal economic growth.

**Table 2**  
**Distribution of the Unemployed by the Duration of Their Unemployment**

Duration of Unemployment	Current Unemployment: In Sept. 1999		Recent Unemployment: Between Sept. 1998 and Sept. 1999	
	Percent of Total	Percent Cumulative	Percent of Total	Percent Cumulative
<= 1 month	3.3	3.3	22.1	22.1
> 1-6 months	56.0	59.3	49.5	71.6
> 6-12 months	20.7	80.0	14.9	86.6
> 12 months	20.0	100.0	13.4	100.0
Total	100.0		100.0	
Average Duration of Unemployment				
All Cases	9 months		7 months	
Cases <= 12 months	4.3 months		3.5 months	

*Note: The period of 'current unemployment' refers to the time that the unemployed had spent without work at the time of the survey. 'Recent unemployment between Sept 1998 and Sept 1999' refers to all cases which were unemployed at any point in time during this year, and includes the sample of the current unemployed.*

The next factor that we need to consider is the duration of the previous job that the unemployed had, as this determines the amount of savings that they will have accumulated. It is evident from Table 3 below that the unemployed on average have spent significantly less time in their previous jobs than the general labor force. A particularly worrying result is that 60 percent of the unemployed did not stay in their job for a minimum period of one year, the period they would theoretically need to contribute to the insurance program in order to claim benefits (unless they have funds accumulated in their account from a previous job). And only 9 percent of the unemployed were in their previous employment for a minimum of five years, the period that is considered sufficient to cover the average duration of unemployment without additional funding from the Solidarity Fund.

**Table 3**  
**Distribution of the Unemployed and Employed by Duration of Employment**

Duration of Employment	Employed		Unemployed	
	Percent	Percent Cumulative	Percent	Percent Cumulative
Less than 6 months	19.0	19.0	44.0	44.0
7–12 months	7.3	26.3	15.6	59.6
> 1–3 years	18.5	44.8	24.0	83.6
>3–5 years	13.5	58.3	7.4	91.0
More than 5 years	41.7	100.0	9.0	100.0
Total	100.0		100.0	

*Note: the data refers to the duration of their previous job in the case of the unemployed and to their current job in the case of the employed. No ratio is calculated for this variable the duration of employment is an evolving variable for the employed.*

Table 1 of this paper showed that less than a third of the unemployed had open-ended contracts in their previous jobs. Of this third, Table 4 shows that 71 percent were dismissed for unjust reasons, which amounts to 22 percent of the total unemployed. These are therefore the unemployed who would be entitled to the full insurance benefits, i.e. the accumulated savings in their accounts and severance payments. They would also have access to the Solidarity fund should they need it.

**Table 4**  
**Distribution of Former Wage-Earners with Contracts by Reason for Loss of Employment**

Reason for Loss of Employment		Open-ended Contract
‘Unjust’ Reasons	Necessity of the Firm	61.8
	Closure of the Firm	9.1
‘Just’ Reasons	Voluntary Change	16.4
	Expiration of Contract	0.0
	Other	12.7
Total		100.0

Another important characteristic of the unemployed to look at in this section is the level of income they had in their previous job, as this determines the amount of unemployment benefit to which they would be entitled under the new insurance program. The ratios in Table 5 show that unemployment is far more likely among the lowest income categories, especially among workers

who earn less than the minimum wage. The lowest income categories (workers earning two times the minimum wage or less) constitute 80 percent of the unemployed. In their cases, unless they receive top-up funds from the Solidarity Fund, the accumulated savings in their individual accounts would not be enough to keep them from falling below the poverty line.

**Table 5**  
**Distribution of the Employed and Unemployed by Level of Income**

Income	Percent Employed	Percent Unemployed	Ratio, Percent
1 minimum wage (mw) or less	10.2	32.9	34.35
Between 1–2 mws	31.4	47.1	19.24
Between 2–3 mws	21.4	12.9	8.74
Between 3–4 mws	8.8	3.1	5.21
More than 4 mws	28.2	4.1	2.26
Total	100.0	100.0	13.7

*Note: The income categories were calculated based on multiples of the minimum wage effective in September 1999, which was \$90,500, roughly US\$200 at the time.*

In addition to these factors mentioned so far, we have to consider that approximately 12 percent of the unemployed are excluded from the insurance for age reasons.

The overall conclusion that we can draw from this comparison of the characteristics of the unemployed and the employed is that the former generally held jobs of a far lower quality than the latter. The comparison has shown that the unemployed are generally more likely to have been wage-earners with atypical contracts or none at all, with significantly lower levels of income and a high likelihood of not having worked for long enough in their previous jobs in order to be covered by this insurance program. If we take all the variables discussed above into account together, we must conclude that the conditions under which the unemployed would be protected by this insurance program exclude the vast majority of the unemployed.

## 5. EVALUATION OF THE CHILEAN UNEMPLOYMENT INSURANCE PROGRAM AND CONCLUSIONS

The introduction to this paper mentioned that this unemployment insurance program has been widely acclaimed as a model for other developing countries who wish to protect their workers against the eventuality of becoming unemployed but do not have the fiscal resources required

for implementing traditional forms of unemployment assistance. This paper has explained why the unemployment insurance system was devised in its particular way given the context of unemployment protection in Latin America and the specific context of the theoretical and political debates regarding unemployment insurance in Chile.

We must now examine whether Chilean workers are generally more protected now through this program than they were before. Second, we must assess whether the unemployed will really be adequately protected by this program as the Chilean government claims. Third, we will examine whether the other claims that the Chilean government made with regard to this program are justified. These claims are first that the program avoids issues of moral hazard and second that it will make labor markets more flexible and function more smoothly by reducing the cost of severance payments for employers. This section also discusses the institutional limitations of this program. The paper concludes by discussing whether this insurance program really could serve as a model for other developing countries, and raises some policy issues that should be considered as a result of this discussion.

The first question we should ask with regard to this unemployment insurance is whether workers in general are now more protected against unemployment than they were before the system was implemented. The answer to this question is that overall they clearly are, and we shall examine how the system affects each category of worker in turn.

The self-employed and workers who did not have a written contract and become unemployed are as unprotected by this new insurance system as they were before. They are excluded *a priori* and cannot even contribute voluntarily to the program.

Workers who become unemployed for so-called 'just' reasons (expiration of contract, voluntary resignation or misconduct) are more protected by this program, as they are entitled to the payout of their savings from their individual accounts. This effectively represents a proportion of the severance payment program currently in place, which under the existing statute they would not be entitled to. In the case of workers with short-term contracts or workers with



open-ended contracts who did not work in their previous jobs for a long time (short tenure), these savings may not amount to much,<sup>44</sup> but under the previous system they received nothing. However, for them, the new system functions not as unemployment insurance but as an obligatory savings program.

Workers who had open-ended contracts in their previous jobs and lost their work due to so-called ‘unjust’ reasons (mainly economic reasons) are significantly more protected by this new unemployment insurance, as they are effectively entitled to the same amount of severance pay as they were before but in addition may receive payments from the Solidarity Fund if the savings in their own accounts are insufficient to cover five months of unemployment. This is likely to be the case for all such workers with relatively low incomes who did not work for at least five years in their previous jobs. And the Solidarity Fund will provide more generous support than the present unemployment subsidy, albeit for a shorter period of time (five versus 12 months). So it is for this category of workers that the new program will actually function as insurance and not merely as an obligatory savings program.

Finally, the last category of workers that we need to look at is those who do not actually become unemployed at all, for they also benefit from this program. All savings that are accumulated in their accounts during their working lives are paid out to them upon retirement or alternatively while they are in between jobs. Under the previous system, they would not have been entitled to any funds.

The second question that we should ask with regard to this unemployment insurance is whether it constitutes progress in terms of protecting workers who are vulnerable to significant reductions in income when they become unemployed. At the ceremony that instituted the unemployment insurance into law, President Lagos claimed “Chile’s workers will participate in a system of tripartite capitalization that will provide support to those who suffer the loss of their employment for whatever reason.... We therefore hope that this help will provide those families who find themselves faced with the drama of losing their source of income with a degree of

security” (Lagos, 2002).

From the outset, President Lagos placed the insurance program into a context of social justice.<sup>45</sup> However, the empirical evidence presented in the previous section shows that the vast majority of the unemployed will either not benefit from the program at all, or receive such minimal benefits (in the case of workers with short-term contracts) that the program will make little difference to them. As we saw from the data presented above, this is because most of the unemployed will not have complied with the criteria they are required to fulfill in order to claim benefits. Mainly, they will either not have been able to contribute to the program for long enough before becoming unemployed due to the extremely high job turnover rates of the unemployed or because they never had a formal written contract. This leaves workers who are the most vulnerable to becoming unemployed without adequate protection.

It is not that the conditions under which the unemployed can claim benefits are unduly restrictive in this program. The inadequate protection offered by this program derives from the discrepancy between its theoretical stipulations and the reality of the Chilean labor market. Despite its innovations, the program is modeled on traditional forms of unemployment insurance and existing legislation in the Latin American region. For example, it is not unusual for unemployment insurance systems to stipulate that a worker must have contributed for at least 12 months before being entitled to unemployment benefit. The problem is that in the rather more precarious labor markets of developing economies, a large proportion of the workers rotate among highly precarious jobs and will thus never be able to comply with such a condition.

One of the main problems with the insurance program is that it is called ‘insurance’ and that it is presented to the public as a program which will protect the most vulnerable workers. First, the term ‘insurance’ is misleading as only a very small proportion of the unemployed will be able to benefit from the program’s insurance element, the Solidarity Fund. For most workers, the program bears more resemblance to a mandatory savings program. And second, there is a discrepancy between how the unemployment savings program is presented in the political

discourse of the government, and the real practical impact it will have.

Government officials who instituted this program recognize that the contribution from employers is probably too low. However, they take the view that it is better to implement a basic insurance and then improve it over time. The idea seems to be to gradually pass from a severance payment system to this unemployment insurance system by increasing the funds paid into the individual savings accounts and decreasing the amounts that are paid as a lump sum severance package upon dismissal (Acevedo and Eskenazi, 2004).

It has been widely noted in the literature that Latin American unemployment insurance systems are inequitable, precisely because they channel scarce resources to a segment of the labor force that is not necessarily the poorest.<sup>46</sup> Cortázar, for example, argues that the previous system of unemployment provisions in Chile created a strong segmentation of the labor markets between insiders in the formal sector who enjoyed strong job security and informal workers who have access to limited and very unsatisfactory unemployment protection (Cortázar, 1997). However, this new unemployment insurance is no different: it will also protect the most precarious jobs the least. As such, it will not be able to function as a safety net for the poor either. It should be remembered at this point that we are talking about a developing country that does not have extensive alternative means of social protection, so that those who do not benefit from the unemployment program would not be covered by alternative funds.

The third question we must ask with regard to this unemployment insurance program is whether it really does fulfill the claims that the Chilean government made with regard to its efficiency and its impact on labor market flexibility.

The program is certainly efficient in the sense that it largely avoids issues of abuse and moral hazard. In fact, the only way the system can be abused is if an unemployed person claims a benefit from the Solidarity Fund while either working informally or having exited the labor force (i.e. not looking for a new job while claiming benefits). The government has no way of monitoring this behavior, but the limit on the number of months you can claim from

the Solidarity Fund, on the amounts of benefits which decrease during these five months (see Appendix), and on the number of times (twice in five years) workers can claim from it, limits this potential moral hazard. In the case of all other claims made through this insurance system, beneficiaries are essentially claiming their own money, so this cannot constitute a moral hazard. In addition, the same point must be made about this program as was made above about other unemployment insurance programs in Latin America: its coverage is so low, that it cannot constitute a significant moral hazard. The Chilean government can therefore accurately claim that this program really does largely avoid issues of moral hazard.

The other claim that the Chilean government made regarding this program is that it would make the labor market more flexible and function more smoothly. This claim is more questionable because it is mainly based on the idea that employers will not have to make full severance payments to all workers that they dismiss in times of crisis. However, the total provision that employers make towards dismissals is only one-quarter of the total cost so that three-quarters of the severance pay still has to be paid at the time of dismissal.

The Chilean Ministry of Labor also argues in all its analytical papers on this program that it will contribute to better labor relations because it reduces the incentive for workers to get themselves dismissed for unjust reasons as opposed to resigning voluntarily. However, this is unlikely to be the case since unjust redundancy entitles them to full severance pay as opposed to just the funds accumulated in their accounts.

As for workers finding better jobs by virtue of the fact that they were supported by this insurance during their time of unemployment and could therefore afford to spend longer looking for a job most suitable to them, this claim can only be true for those who are actually fully covered by the program. But since it does not cover the vast majority of the unemployed, this factor will hardly have an impact on the labor market as a whole.

So while the Chilean government's claims on the new unemployment insurance program's efficiency in avoiding moral hazard are justified, its claims regarding its contribution to making

the labor market as a whole run more efficiently are not justified.

We must also consider the institutional limitations of this insurance program. First of all, like all other labor market legislation in Chile, it excludes the self-employed a priori. They cannot even participate voluntarily. Since the self-employed in Chile are not covered in the case of work related accidents or any other misfortunes that may prevent them from being able to exercise their profession, it would make sense to implement an insurance system that would cover them in all such eventualities. For the self-employed the inability to work can often cause severe deprivation for them and their families.<sup>47</sup>

Another group of people who are not covered by this insurance is the long-term unemployed. Since the insurance program was only designed to cover frictional unemployment, they are not covered beyond the first five months of unemployment. This ties in with another institutional limitation of this program, which is that it was not designed as part of a coherent labor policy package. Although the unemployed are automatically registered with municipal employment agencies, and are also given priority access to official training programs, there is no coherent program that will advise the unemployed as to their professional development. Furthermore, the training programs that the unemployed can participate in are designed as short courses that may update a workers skill set, but they will not be enough to either significantly change his job prospects or insert himself into a different form of employment.

We should also consider that this unemployment insurance is neither means tested nor does it take into account whether the subsidy received will be sufficient to maintain the people who will depend on it, as the circumstances of the unemployed individual (e.g. size of a family or whether other family members are working) are not considered. Since a very basic welfare system does exist in Chile, it would make sense to establish the institutional linkages that can combine unemployment insurance with other welfare measures. This should be possible without too much additional cost since both employment and welfare offices are supposed to exist in every municipality in Chile. As Márquez writes: “unemployment insurance has a role as part of

the safety net, but there is a need for complementary mechanisms that protect the poor who do not have protected employment contracts” (Márquez, 1999: 7). At the very least, unemployment benefits and other social security mechanisms should be linked.

We should further note that this insurance system will not eliminate the need for emergency employment programs in times of economic downturn, principally because the program will not cover those workers who are most likely to become unemployed. But we should also remember that this unemployment program was designed to cover only frictional unemployment so if unemployment rates and duration increase, even workers covered by the insurance system will not be covered for these eventualities. If they cannot find a new job they too will need to take recourse to public employment programs.

Given the limitations of this unemployment insurance, and especially given the fact that the great majority of the unemployed will not be covered by this program, we must certainly ask whether it should serve as a model for other developing countries.

In terms of its institutional design, this author would argue that the unemployment insurance program constitutes progress if we compare it to other such programs in the region. Although it excludes the self-employed and is linked to the existing severance payment legislation, which is typical of the region, it does limit moral hazard factors and also makes some attempt to link unemployment benefits with some form of employment mediation and professional training. However, countries contemplating the implementation of such a scheme should establish higher contributions than the Chilean insurance scheme does. We should also refrain from referring to this scheme as ‘unemployment insurance’ and call it an ‘individual savings scheme,’ as its insurance component is minimal. And it is certainly misleading to present this scheme as a safety net for the poor or as a program that will cover the unemployed. Such a scheme should never be considered as more than a component of a more comprehensive social security system.

## APPENDIX: DETAILS OF THE UNEMPLOYMENT INSURANCE PROGRAM

## COVERAGE

- The program will cover all wage-earners normally subject to the regulations of the Labor Statute (*Código del Trabajo*), including workers with short term or project based contracts.
- The program excludes domestic employees, apprentices, minors (<18years), pensioners, and temporary workers.
- All employees contracted after this insurance becomes law will automatically be obliged to contribute. Those under contract at the time of ratification will be given the choice of affiliation. This means that the unemployment insurance program will be rolled out gradually over the coming decades to cover the entire labor force of the formal sector.
- The program proposes insurance against loss of employment regardless of its cause (dismissal, voluntary resignation, retirement, permanent injury and death). Workers dismissed for unjust reasons have the right to additional severance payments from their employers.
- A minimum of 12 monthly contributions have to have been paid into the insurance program (continuous or not) either since affiliation to the program or since the last withdrawal of funds. In the case of fixed term contracts the minimum period of contribution is six months.

## FUNDING

- The current proposal will be financed 80 percent by the employers and 20 percent by the employees. Contributions are based on the employee's current gross monthly salary; 2.4 percent is paid by the employer, of which 1.6 percent goes into an individual account, the *Cuenta Individual de Cesantía (CIC)* and the remaining 0.8 percent is paid into a centrally administered Solidarity Fund (the payment structure of which is described below). The employee's contribution of 0.6 percent goes entirely into the individual account. Over the

course of one year, the contributions accumulate to 26.4 percent of a monthly gross salary. The contributions are only adjusted to changes in the employee's gross salary during the 11 year period of contribution, and do not take into account any salary increases that may occur thereafter if the employee stays at the same firm.

- For workers with fixed term contracts, employers have to contribute 3 percent of the employee's gross salary into the CIC only, and no contribution is made to the Solidarity fund.
- The worker has the right to receive all interest accumulated on the funds in the CIC minus the cost of their administration.
- In cases of dismissal for business reasons, the employer has to make up the difference between the contributions already made into the account of the employee and the employee's legal right to severance payments (one month's salary per year of service with a ceiling of 11 months). This means that the employee's own contribution of 0.6 percent constitutes an additional forced saving, and functions as a top up to the employer's contributions. The money paid into the Solidarity Fund, however, is not deducted from the severance payments due, thus representing an additional or new tax to the employers.
- If the employer has to pay severance monies, fluctuations in the value of the portfolio and the administrative cost of the portfolio management are subtracted from the employer's contributions. If the value of the portfolio increases, the employer pays less, if it decreases the employer has to make up the lost funds. The employee only benefits or suffers from market movements on his contributions of 0.6 percent.
- The employer is obliged to pay this insurance up to a limit of eleven years (if the employee stays that long with the same company) after which no further contributions have to be made to the insurance.



## WITHDRAWALS

- The first withdrawal can be made 30 days after the loss of employment, provided the worker is still unemployed at that time.
- The worker can withdraw the funds from their individual account in 5 sums of equal amounts, unless their account contains two monthly salaries or less, in which case, the sums to be withdrawn are determined by the table below.
- Any unemployed person who finds a new job before the end of the period that the CIC account provides funds for, is free to withdraw the remaining funds in the account or to leave them in the account as an additional security in cases of future unemployment, in which case they will be added to the funds accumulated thereafter, and the total amount will be taken as the basis for calculating future withdrawals. In either case the clock for the new employer is reset to zero as any funds remaining in the account do not affect the new contributions to be made. The same conditions apply if the worker finds a new job within 30 days (i.e. before having made any withdrawal).
- In the case of workers with short term or project based contracts, they can only make one single withdrawal of their entire accumulated funds.

## PUBLIC SUBSIDIES FROM THE SOLIDARITY FUND

- Only wage-earners who held open-ended contracts and were dismissed for unjust reasons are entitled to payments from this fund, if their own funds are insufficient.
- If the balance of the CIC account is insufficient to finance the amounts stipulated in the table below, the worker will be entitled to receive the difference from the Solidarity Fund once own funds have been exhausted.
- The fund supports the unemployed for a maximum period of five months. The amounts received are related to the level of income last received by the beneficiary on a decreasing scale, with the

Duration of unemployment (months)	Minimum Payments \$	Payments in percent of the last 12 months average wage	Maximum Payments \$
1	65,000	50%	125,000
2	54,000	45%	112,500
3	46,000	40%	100,000
4	38,500	35%	87,500
5	30,000	30%	75,000

- Individuals can benefit only twice in any five year period from the Solidarity Fund.
- The fund is limited to paying out a maximum of 20 percent of its previous month's balance during any one month. Should the total amount of claims made exceed this amount, individual benefits will be reduced proportionately in order to not exceed the stipulated maximum.
- The unemployed loses the right to benefits from the Solidarity Fund if s/he refuses a job offer by the local council's employment office provided that the job did not offer less than 50 percent of the individual's former wage. The individual also loses his right to benefits if he refuses a scholarship for professional training offered by the official training agency, SENCE.

#### OTHER BENEFITS

- Any unemployed worker benefiting from the program and dismissed for unjust reasons has preferential right of access to training programs offered by SENCE.
- The unemployed are entitled to public healthcare services for at least six months after they cease employment and once they have cancelled their membership of their respective health insurance (ISAPRE).<sup>48</sup>
- The fund administrator is obliged to inform local employment agencies of any beneficiaries of the system so that they can be incorporated into the national information system for job seekers in order to help the unemployed find new jobs.

#### ADMINISTRATION OF THE FUNDS

- The funds (both individual accounts and the Solidarity Fund) are administered by a single entity which was determined by a public bidding process. All banks, fund administrators, insurance companies and other financial institutions could bid for the license which has a maximum duration of ten years. The idea of picking one sole administrator is driven by the desire to reduce administration, transaction and marketing costs to an absolute minimum while maintaining a degree of competition through the licensing procedure.
- The responsibilities of the chosen fund administrator consist of collecting the contributions, the administration, maintenance and investment of the funds, the payment of benefits and the capacity to check compliance with the requisite criteria of the potential beneficiaries.
- The funds are invested according to the regulations established by DL 3.500 for Type 2 style pension funds. A specific regulation of the funds will be established at a later date.
- The investment body is regulated by the regulatory agency of the pension funds.
- The commission for the administration of the funds is 0.6 percent of the total value of the funds.

#### USER COMMISSION

- The entire process is overseen by a committee of users consisting of three representatives each of employers and beneficiaries, and chaired by an academic. Their function is to oversee the regulation process and the criteria applied in this process. It is hoped that the institution of such an entity will enhance the legitimacy of the administration process. Its reports are public.

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## ENDNOTES

<sup>1</sup> Ministerio del Trabajo, 2000c. Law N°19.728, Código del Trabajo.

<sup>2</sup> Advisors from the Chilean Ministry of Labor have travelled to Argentina, Paraguay, Peru, Ecuador and the Dominican Republic in order to advise local governments on the design of unemployment insurance schemes (Source: Interview with an official of the Ministry of Labor).

<sup>3</sup> This paper is based on a survey of the quality of employment conducted in Greater Santiago in 1999 as part of the author's Ph.D. fieldwork. It was the first survey undertaken in Chile to interview the unemployed about their previous employment situations, which means that it can be used to assess the practical effect of this unemployment insurance scheme. The universe of the survey consisted of all households in Greater Santiago, and the sample was fully representative with a margin of error of 3.5 percent at a 95 percent confidence level. The survey was carried out by the survey department of the Facultad *de Ciencias Económicas y Administrativas* of the *Universidad de Chile, Santiago*.

<sup>4</sup> These four points were gleaned from a body of published and unpublished literature by members of the Chilean government who were involved in designing the new insurance scheme, and from a series of discussion papers published by prominent labor market experts in Chile. These papers include: Acevedo and Eskenazi (2004), Beyer (2000), Bravo (1998), CILAS (2000), Coloma (1993, 1996 and 1997), Cortázar (1995), *Ministerio del Trabajo* (2000a, 2000b, and 2000c), Mizala and Romaguera (1996), Paredes (2000), Pérez (1998), Velásquez (1996 and 1998) and Vergara del Río (2000).

<sup>5</sup> The unemployment insurance schemes that do exist will be discussed in the following section of this paper.

<sup>6</sup> The exact specifications of periods and conditions of advance notice vary from country to country. In Brazil, for example, the required notice period is one month, and workers are legally entitled to devote two hours of each work day during this period to searching for new employment.

<sup>7</sup> Severance pay legislation varies from country to country. Jamaica and Paraguay are the only countries that do not have severance payment legislation. Some countries also oblige employers to make provisions for future severance payments by paying a proportion of their wage bill into individual savings accounts for their employees, on which the latter can draw upon becoming unemployed. This particular feature of Latin American labor markets will be discussed in more detail in the next section. See Jaramillo and Saveedra (2004) for a detailed summary of redundancy cost and legislation in Latin America.

<sup>8</sup> The IADB (1998), for example, reports that Latin America's Labor Codes are much more restrictive than those of OECD countries as regards redundancy legislation.

<sup>9</sup> Pages and Heckman (2003), for example, argue that the legislation regulating job security in the shape of various types of mandated severance pay packages impact both the equity and efficiency of Latin American labor markets. And Montenegro and Pagés (2003) argue that job security regulations reduce the employment opportunities of the young and unskilled, and may force some workers into self-employment. Pages and Saavedra (2002) state that "among Latin American labor laws, concerns for balance between social protection and labor market efficiency have been overridden by desires of pure social protection."

<sup>10</sup> Theoretically they can sue their employer to for the full severance pay to which they are entitled, but as court proceedings are costly, time consuming, their outcomes uncertain, and do not provide workers with the immediate funds that they need, most of these cases are settled out of court.

<sup>11</sup> Unfortunately, very few studies have been undertaken that take compliance with legislation into account when examining their effect on the labor market. For a more detailed discussion of this point in relation to the results of this survey, see Sehnbruch 2003.

<sup>12</sup> During the neoliberal administration of Pinochet in Chile in the 1970s and 1980s, the military administration devised employment programs which lowered the official unemployment rate by 13.3 percent in 1983 (See Díaz and Martínez, 1996). Despite the stigmatization associated with emergency employment programs

(described by Graham, 1994), they remain a popular policy for controlling unemployment rates in Latin America. However, with the exception of successful programs like “Chile Joven,” these programs must be viewed as a measure to prevent extensive poverty, not as welfare to work programs because they are not sufficiently combined with professional training. See Márquez (1999) for descriptions of the employment programs in Argentina, Brazil, Chile, Costa Rica, Jamaica, Mexico and Peru.

<sup>13</sup> See Acevedo and Eskenazi (2004).

<sup>14</sup> For example, the *Plan Trabajar*. See Delamata (2004).

<sup>15</sup> Source IBD (2003), p. 282. These figures should be treated with some caution, however, as different countries classify their labor market expenditures under different headings. The figures do, however, illustrate a general trend.

<sup>16</sup> Source: ILO 2003. The ILO’s definition of what does and does not constitute the informal sector can be criticized on many accounts for being an inaccurate measure of informality. (See Sehnbruch 2003 for a critical discussion of this definition.) The advantage of the ILO’s definition, however, is that it can be measured consistently across Latin America and across other developing regions, since its component variables are contained in most labor market surveys.

<sup>17</sup> See for example Ferrer and Riddell (2004) and Freije (2001). However, the informal sector does not constitute a greater proportion of the labor market in Latin America than other developing countries, except for Eastern Europe (see Maier and Rauch, 2000: Exhibit VI.1.), and many of these countries have much more rigid legislation.

<sup>18</sup> According to the IBD, Latin American per capita incomes are only just reaching the levels at which industrialized nations instituted their insurance programs (IBD, 2003).

<sup>19</sup> The use of the term ‘unemployment assistance’ is based on Atkinson and Micklewright’s definitions and is distinct from unemployment insurance. See Atkinson and Micklewright, 1991.

<sup>20</sup> In the Chilean case, the unemployment assistance included in this list will be replaced in due course by the new unemployment insurance discussed in the following sections of this paper. As for Venezuela, Márquez (1999) states that the unemployment insurance scheme to that date had been legislated but not yet implemented.

<sup>21</sup> The exception to this rule is the case of Brazil, which finances its unemployment insurance scheme through a 6.5 percent tax on total sales. For details on the various unemployment insurance schemes in Latin America, see for example Conte-Grand (1997), Islas (2002), Márquez (1999), Marshall (1996) or Mazza (1999).

<sup>22</sup> A more detailed discussion of these schemes can be found in Ferrer and Riddell (2004).

<sup>23</sup> One of the problems that analysts have identified with the FGTS is that workers are not entitled to the benefits if they are not dismissed for ‘unjust’ reasons (e.g. if they resign voluntarily). This creates a problem of moral hazard as it leads to collusion between employers and their employees as the latter attempt to be made redundant in order to gain access to the funds.

<sup>24</sup> Bravo (1998), for example, begins his discussion of the unemployment insurance proposal with a discussion of the nature of risk, and the conditions under which companies can diversify this risk. The problem of ‘adverse selection’ (i.e. that individuals more likely to lose their jobs, are also more likely to insure themselves against this risk) make unemployment insurance an unsuitable business for private companies.

As regards the problem of ‘moral hazard,’ he argues that countries which pay benefits for a long period of time also suffer from longer unemployment duration and higher unemployment rates. His line of argument is echoed by Beyer (2000), Coloma (1993, 1996, 1997) and by Cortázar (1995 and 2001). The Chilean government’s documents also follow this argument (see Ministerio del Trabajo (2000c), SAFP (2002)), as do the official speeches that presented the insurance scheme to the public (e.g. Solari, 2002).

<sup>25</sup> Law 19010, approved 1990, *Código del Trabajo*.

<sup>26</sup> Ministerio del Trabajo, 1997.

<sup>27</sup> See Ministerio del Trabajo, 2000a, 2000b and 2000c.

<sup>28</sup> E.g. Hopenhayn, Altman and Feldstein, other references

<sup>29</sup> See Bravo and Haagh (2004) for an excellent analysis of how neoliberal doctrines underlie the positions of employers, and therefore also of the political right, in Chile, thus hampering an efficient and expedient process of labor market reform.

<sup>30</sup> In Chile approximately 16 percent of wage-earners would actually be entitled to the maximum severance pay dictated by the law.

<sup>31</sup> Repeated attempts were made to pass legislation on unemployment insurance in 1990, 1993 and 1997, which all failed due to disagreements over the financial structure and technical detail of the project: in what proportion should it be financed by the government, employers and employees themselves? The points of view are described in Cilas (2000), Ministerio del Trabajo (2000a and b) and Paredes (2000).

<sup>32</sup> From "Mi vision de Pais," Ricardo Lagos, 1999: 63.

<sup>33</sup> Coloma, 2000: 1-2.

<sup>34</sup> Almost no studies or papers published in Chile on the unemployment insurance proposal actually discuss any data. See Coloma (1997 & 2000), Beyer (2000), Ministerio del Trabajo (2000 a & b) and Cilas (2000). Only Beyer (2000) undertakes the exercise of relating periods of employment to periods of unemployment based on 1996 Casen data. But his conclusions are erroneous as he uses data on the employed as a substitute for data on the unemployed, thus neglecting to take into consideration that the latter generally have worse job characteristics than the work force on the whole.

<sup>35</sup> The surveys of the National Institute of Statistics and the Ministry of Planning include some information on the unemployed, as does an annual survey undertaken by the Universidad de Chile. And the Dirección del Trabajo's Encla has included questions on the reasons for dismissals that companies have made and their turnover rates. But none of these sources allow for a comprehensive analysis of the effects that this unemployment insurance scheme will have on the unemployed.

<sup>36</sup> Although in theory it would be possible to construct such information by tracing individuals through repeated surveys, as both the Universidad de Chile and the INE visit the same households repeatedly over a period of a year and 1½ years respectively. However, attempts to do this have failed due to codification problems with the databases that invalidate the methodology, resulting in very small proportions of matching data. So far, therefore, no study looking at employment histories has been undertaken, or at least published.

<sup>37</sup> More detail on the specifics of the scheme can be found in the Appendix.

<sup>38</sup> This is much less than other individual savings account schemes in the region. In Brazil, the contributions to the individual savings accounts is 8 percent, in Argentina is 8-12 percent, and in Colombia 9 percent.

<sup>39</sup> Except the domestic service sector, to which a different unemployment insurance scheme applies (See the Labor Code, Article 163,a). However, since domestic workers are among the most informal jobs in Latin American economies, the coverage of this scheme must be very limited. To the author's knowledge, no data exists so far on this scheme.

<sup>40</sup> Workers with short term contracts or contracts limited to a particular project or service only have to have had contributed to the scheme for six months.

<sup>41</sup> These deductibles save insurance companies the cost of small claims and also the administrative cost associated with these claims. This enables them to charge lower premiums to clients who only want to be protected in case of more substantial claims.

<sup>42</sup> This standard definition is based on the ILO's definition of unemployment. As a measure of what is going

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on in a labor market, this definition is highly inadequate, but the discussion of these inadequacies would have to be the subject of another paper.

<sup>43</sup> The long-term unemployed are disregarded in this analysis, first because they significantly distort the average periods of duration which double if they are included, and second because this insurance scheme is specifically designed for the short-term unemployed.

<sup>44</sup> One quarter of a month's wage in the case of workers who had open-ended contracts per year of service and one third of a monthly wage in the case of short-term contract workers.

<sup>45</sup> See the same speech quoted above and also his election manifesto *Mi País* (Lagos, 1999).

<sup>46</sup> See for example Márquez, 1999.

<sup>47</sup> One common instance in which this occurs is with taxi drivers who crash their cars. Since the latter are generally not even insured against accidents, they lose both their cars and their means of generating income for at least a period of time.

<sup>48</sup> *Instituciones de Salud Previsional*: Private health insurance providers.



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