



SANTIAGO LEVY

Informality

– ADDRESSING THE ACHILLES HEEL OF SOCIAL PROTECTION IN LATIN AMERICA

30 October 2019 | Geneva, Switzerland

United Nations University World Institute for Development Economics Research (UNU-WIDER) gratefully acknowledges the support of the governments of Finland, Sweden, and the United Kingdom to its 2019–23 work programme.

<p>THE GRADUATE INSTITUTE GENEVA</p>	<p>— INSTITUT DE HAUTES ÉTUDES INTERNATIONALES ET DU DÉVELOPPEMENT GRADUATE INSTITUTE OF INTERNATIONAL AND DEVELOPMENT STUDIES</p>
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- Social protection
- Social insurance
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1. Social protection

Social Protection: insurance and assistance

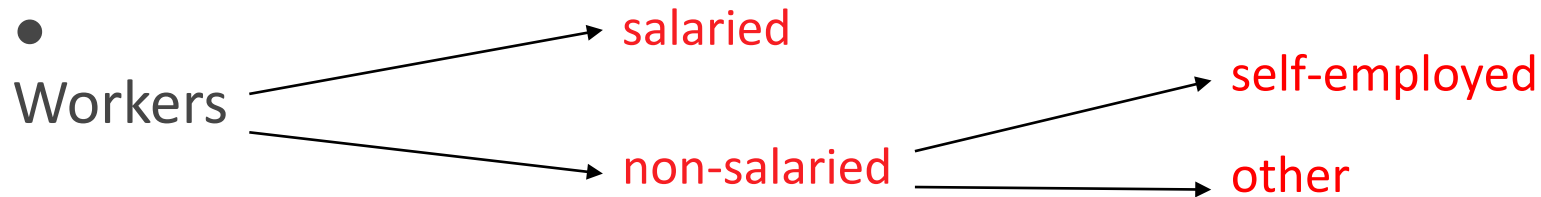
Objectives and target population	Instruments
<p>Protection against risks</p> <ul style="list-style-type: none"> ✓ Illness ✓ Longevity, death, disability ✓ Output and employment shocks <p>All households</p>	<p>Social insurance programs</p> <p>Risk-pooling</p> <p>Usually benefits tied to contributions (often wage-based), but lots of institutional variation and recent innovation</p>
<p>Redistribution/poverty reduction</p> <p>Equity and poverty reduction as ethical imperatives, but also because with imperfect credit markets some redistribution increases efficiency</p> <p>Only for poor/low income households</p>	<p>Social assistance or poverty programs</p> <p>Usually targeted transfers based on income or asset indicators</p> <p>Transfers in-kind or in-cash; sometimes conditioned on behavior (like CCTs)</p> <p>Almost always financed from general revenues</p>

2. Social insurance

Background

- In most countries in Latin America, and in other regions of the world, access to social insurance depends on workers status in the labor market.
- Scope and quality of benefits differ, depending again on labor status.
- This dependency creates substantive issues for:
 - The population covered
 - The fairness of the overall system
 - The risks against which households are protected (illness, unemployment, etc.)
 - The fiscal sustainability of social insurance, and
 - The behavior of firms and workers in reaction to social insurance programs, with spillover effects on productivity and growth.
- Although there are relevant institutional variations across countries, there are also issues that, mutatis mutandis, are common to all.

Distinction between salaried and non-salaried labor (sometimes dependent vs. non-dependent)



- **Salaried:** have a “boss” (firm) and are paid a salary; there is a relation of subordination; workers receive orders from bosses (effort observed, coordination of tasks, and so on). Unions can be formed and minimum wages may apply; regulations on dismissal.
- **Non-salaried:** work on their own, or are associated with a firm but are not subordinated to it; contracts to share risk or elicit effort; payments take the form of commissions, profit sharing, and so on. No minimum wages (no wages!), no unions, and free dismissal (no boss!)

Bismarck's inheritance: CSI and NCSI

Salaried workers: bundled benefits, usually health, life and disability insurance, retirement pensions, and protections against loss of employment

- benefits paid from earmarked wage taxes, hence the (mis)label of “**contributory**” social insurance, CSI
- benefits may also include labor training (Colombia), housing (Mexico), child allowances (Argentina)
- regulations on firing bundled as part of social insurance, but instead of unemployment insurance, mostly one-time severance payments at dismissal time

Non-salaried workers: until recently, uncovered by social insurance. But since 1990s unbundled pension, health and related programs

- benefits paid from general revenues, hence the (mis)label of “**non-contributory**” social insurance, NCSI
- benefits targeted to workers not covered by CSI (often regardless of whether they are salaried or not)
- no costs of firing or minimum wages

Formality and informality

- Defined with reference to a specific regulation (Kanbur).
- Many regulations possible (compliance with registration, tax obligations, size...)
- In LA, reference usually is coverage of CSI:
Formal workers are covered by CSI programs; informal workers by NCSI programs.
- All formal workers are salaried, but informal workers can be salaried or non-salaried (since firms may break the Law).
- Informality and illegality not the same (but this depends on countries' laws).

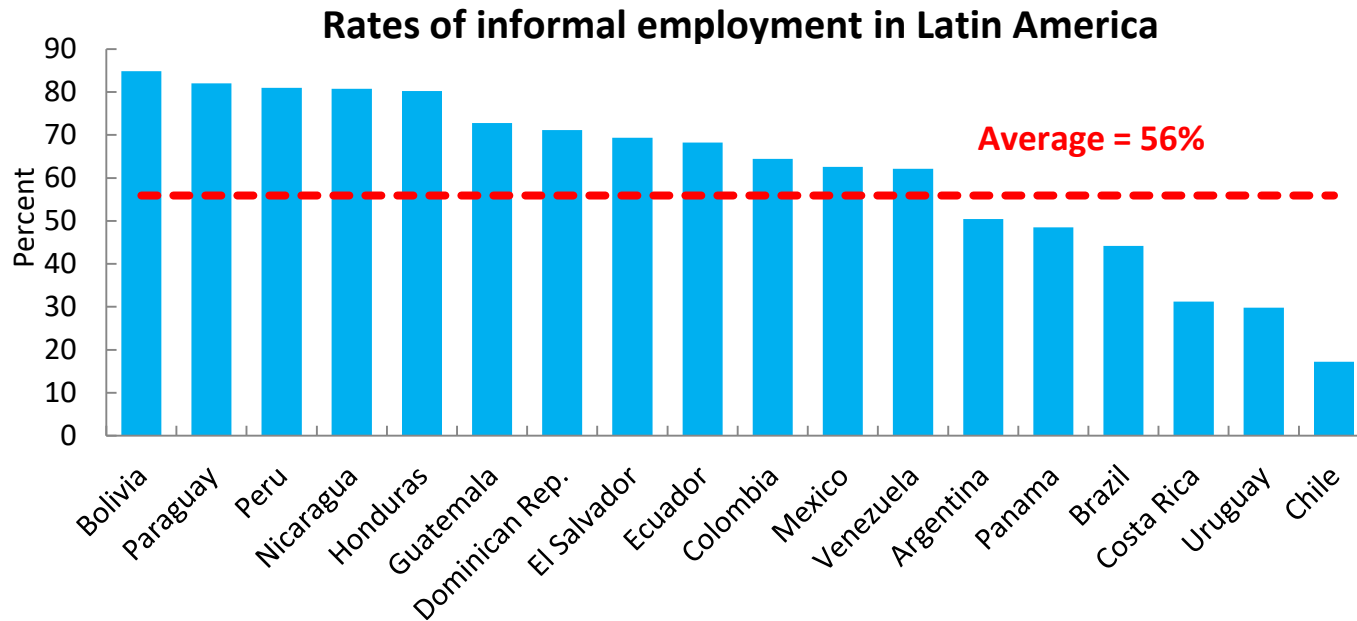
Contributory social insurance

Basic workings:

- Worker hired by firm under a salaried contract and paid a wage w^*
- Contribution is TCSI (usually expressed as a proportion of w^*)
- Firms pay : $(w^* + \text{TCSI})$
- Worker gets: w^* in cash and TCSI in health, pension and other benefits
- Benefits can be provided by public or private institutions, and the pension component can be PAYG or DC (but these aspects not relevant here)
- Even though the firm “pays” for CSI, workers may in large part end up paying in the form of a lower wage (if $w^{**} > w^*$, where w^{**} is the wage that workers would get if there was no CSI)

Three problems with CSI

1. Limited coverage



- By construction, CSI applies only to workers who have a salaried job and whose firm complies with the law; many are legally left out: the self-employed, rural workers, part-time workers, workers in family firms.....and many illegally left out.
- But even under full compliance, CSI will not deliver universal coverage.

Three problems with CSI

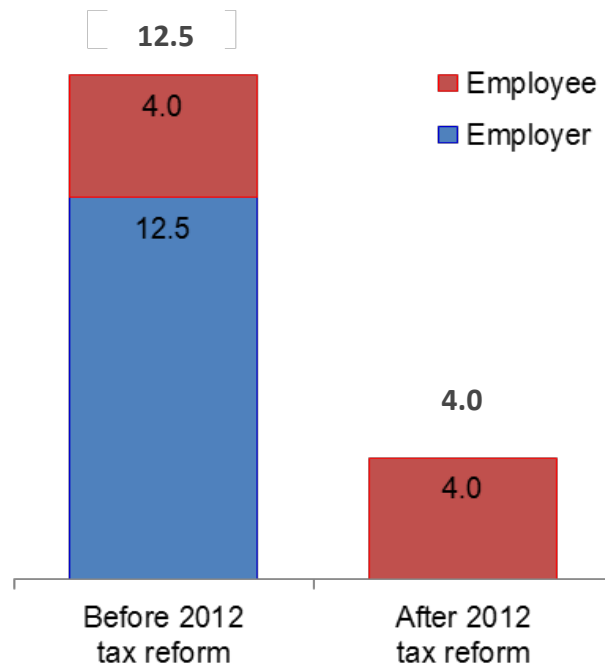
2. Under-valuation of benefits

- Workers might consider that T^{CSI} is worth less to them (because of quality problems, trust, or simply differences in preferences from the government).
- In this case, there is an implicit **tax on formality**:
$$\text{firms pay } (w + T^{CSI}), \text{ but workers get } (w + \beta T^{CSI}), \text{ with } \beta < 1.$$
- This tax will induce firms to limit salaried employment and/or to evade the Law.
- In either case, the result will be reduced legal salaried employment, further reducing the coverage of CSI.
- Bobba, Flabbi and Levy (2018) estimate that $\beta = 0.55$. Since $T^{CSI} = 0.30$, the implicit tax is quite large, about 14% of the wage in the case of Mexico.

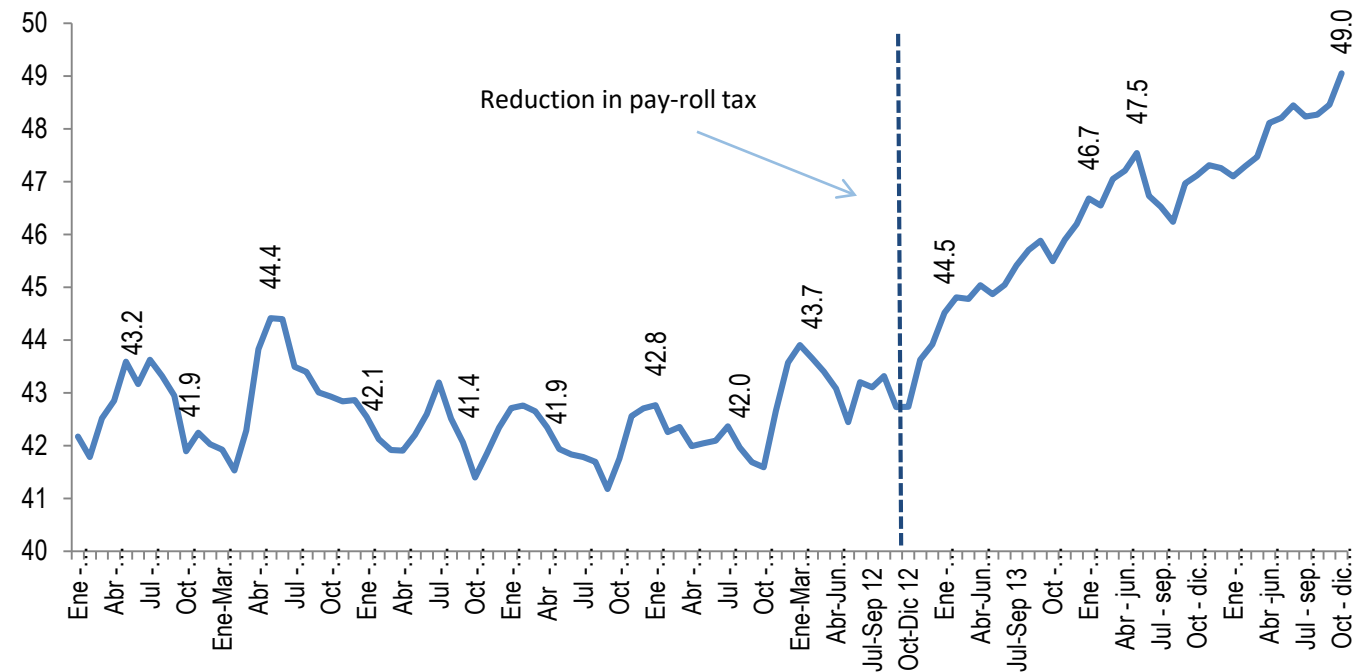
Evidence from CSI programs

Reducing the tax on formality: 2012 reform in Colombia

Health Contributions



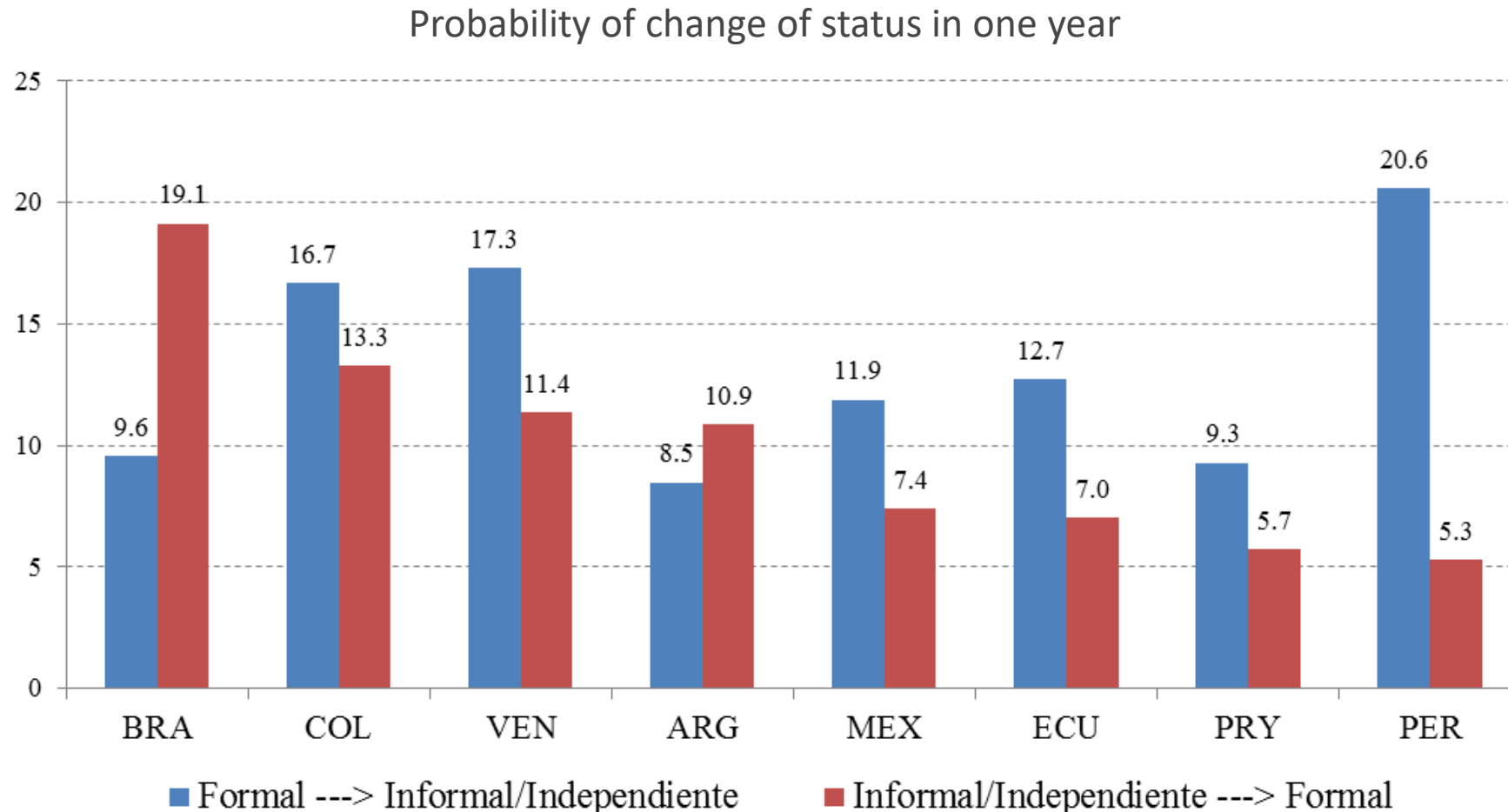
Share of workers contributing to pensions



- Two health care regimes: subsidized for informal workers and contributory (higher quality) for formal ones.
- In 2008 the Constitutional Court ruled that the quality of both systems should be the same.
- Tax reform in 2012 reduced the health contribution for formal employees from 12.5 to 4 percentage points.

Three problems with CSI

3. Large transits across labor status



Implications for social insurance

- Distinction between “formal worker” vs. “worker at present hired formally”. Many workers have spells of formal and informal employment during their life-cycle.
- Only when workers are formal do they save for retirement, get severance pay, and receive similar benefits that are typically not provided by NCSI programs.
- Coverage against risks erratic and incomplete: when formal CSI bundle, when informal, NCSI benefits.
- Efficiency of social insurance much diminished:
 - workers get lower quality health care (interrupted treatments),
 - many will not get a CSI pension (insufficient years of contribution).

Example: Formal-informal transits in Mexico

Retirement pensions

- Average contribution density between 1997 and 2015 of 43%.
- Large variance:

Density	0 - 20	20 - 40	40 - 60	60 - 80	80 - 100
Share of workers	39	16	11	12	23

- Two out of every three workers saving for a pension will not qualify for one!

Health

- In 3 years, 32% of patients with type 2 diabetes receiving CSI benefits transit into informality. Interrupted treatments result in a 43% decrease in quality of care, and 19% fall in clinical results (Doubova et al., 2018).
- One out of every two workers will not qualify for CSI health benefits after retirement.

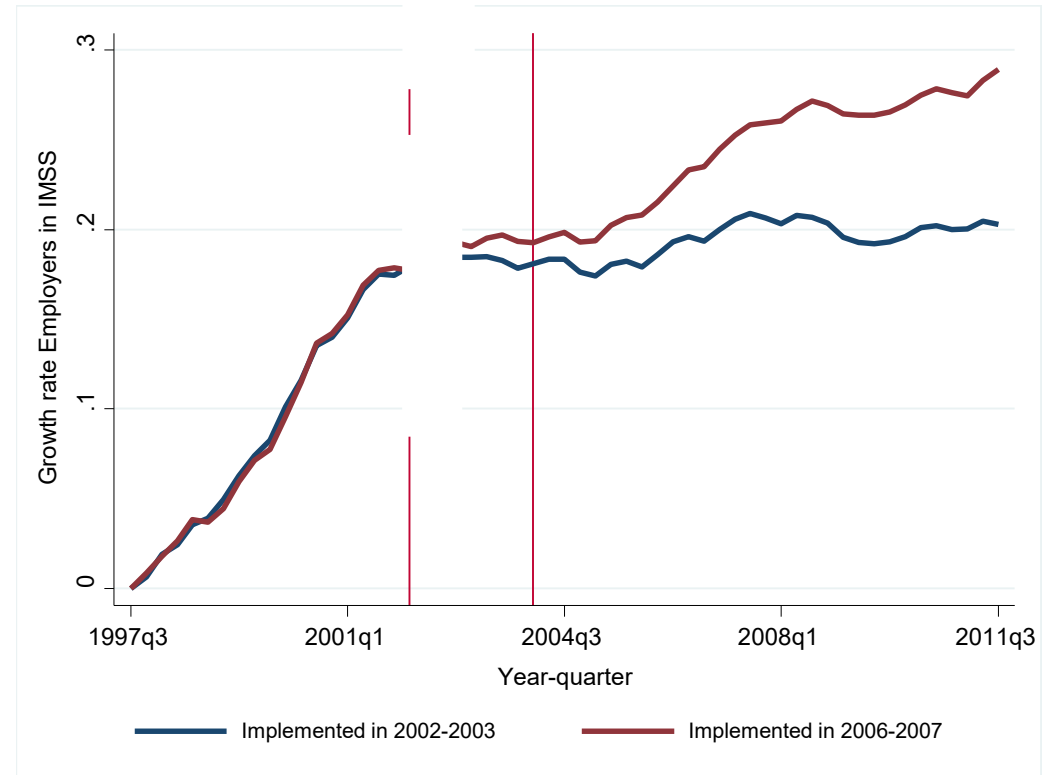
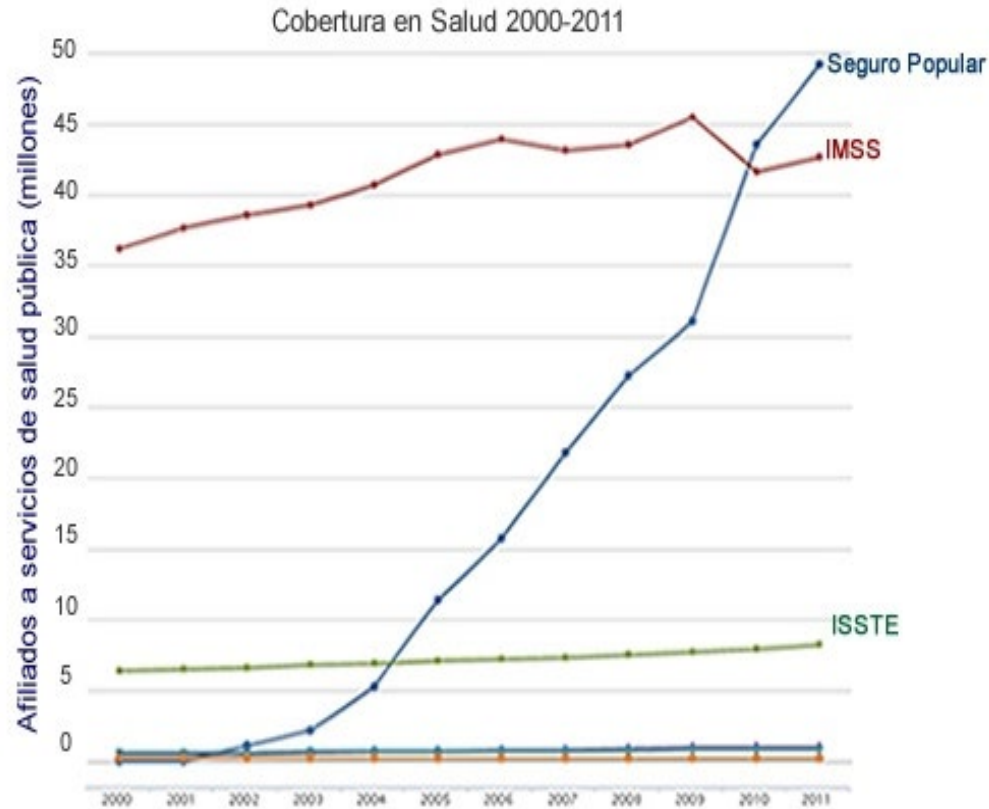
Non-contributory programs to the rescue?

- Beginning in the 1990's, many countries in LA have made efforts to extend the coverage of social insurance to workers excluded from CSI, through NCSI.
- NCSI programs are unbundled and financed by the government, with no firm involved.
- There is substantial variation across LA in terms of what these programs offer, but in most places, they involve health services, retirement pensions, and sometimes other benefits (e.g., day care services in Mexico, family allowances in Argentina).

Benefits and costs of non-contributory programs

- From a social point of view, NCSI programs are clearly welcome, as they provide benefits to workers who would otherwise get none, even if the scope of benefits is less than those provided by contributory programs.
- However, from the economic point of view these programs represent a subsidy to informality, which adds to the effects of the tax on formality associated with undervalued contributory programs, and lower formal employment and productivity.
- There are also implications for national savings, to the extent that the number of workers saving for a pension is reduced as informal employment is stimulated.
- Finally, there are fiscal implications as NCSI do not have a direct source of revenue.

Evidence from NCSI programs, Mexico

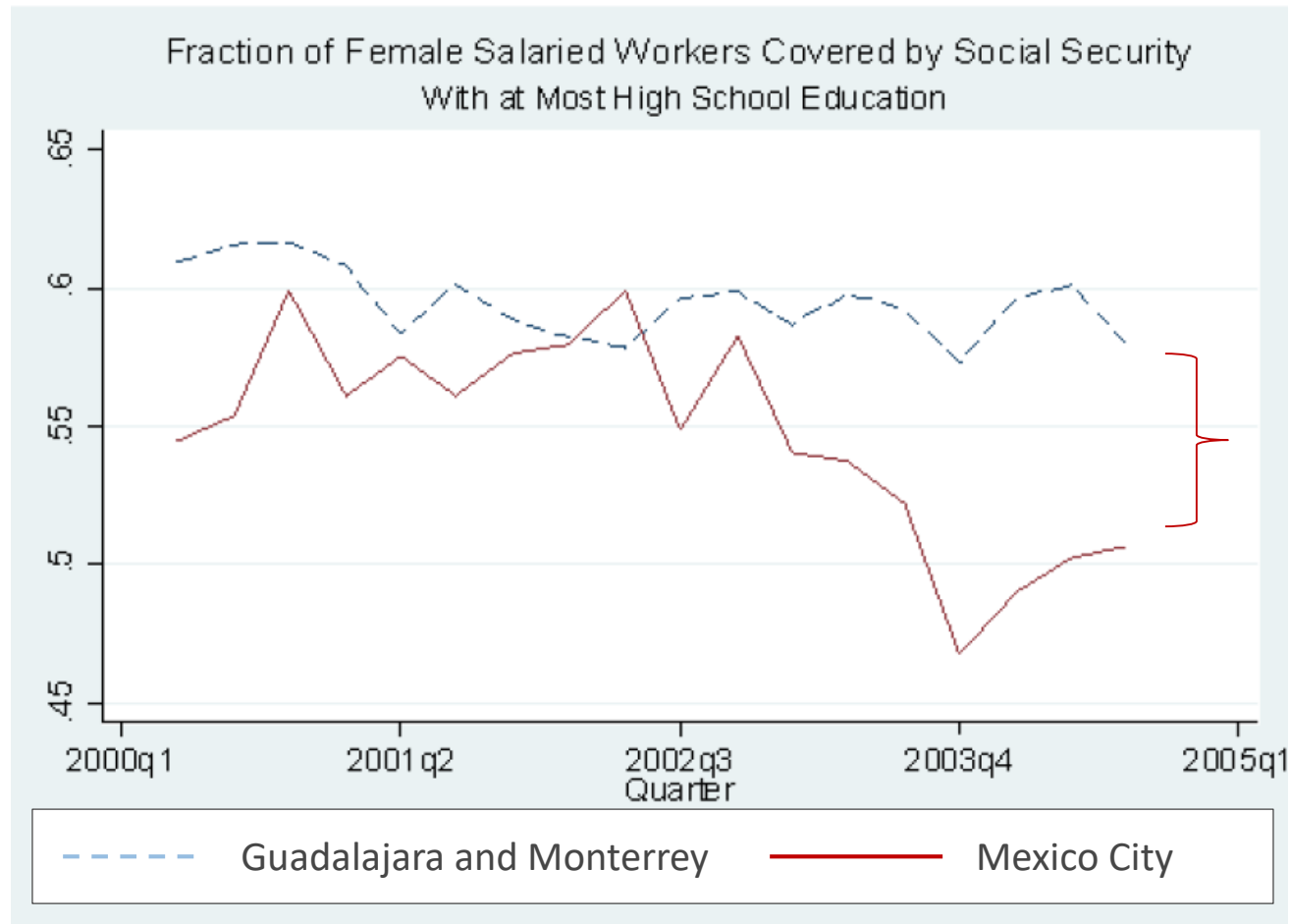


- Reviewing the various papers, Bosch and Pages (2012) find that from 2002 to 2010, Seguro Popular reduced formal employment by between 160,000 to 400,000 jobs, or **between 8 and 20% of all formal jobs created during that period.**

- This difference also provides indirect evidence of higher evasion by firms.

Evidence from subnational NCSI programs, Mexico

Effect of the Mexico City Health Program for Women

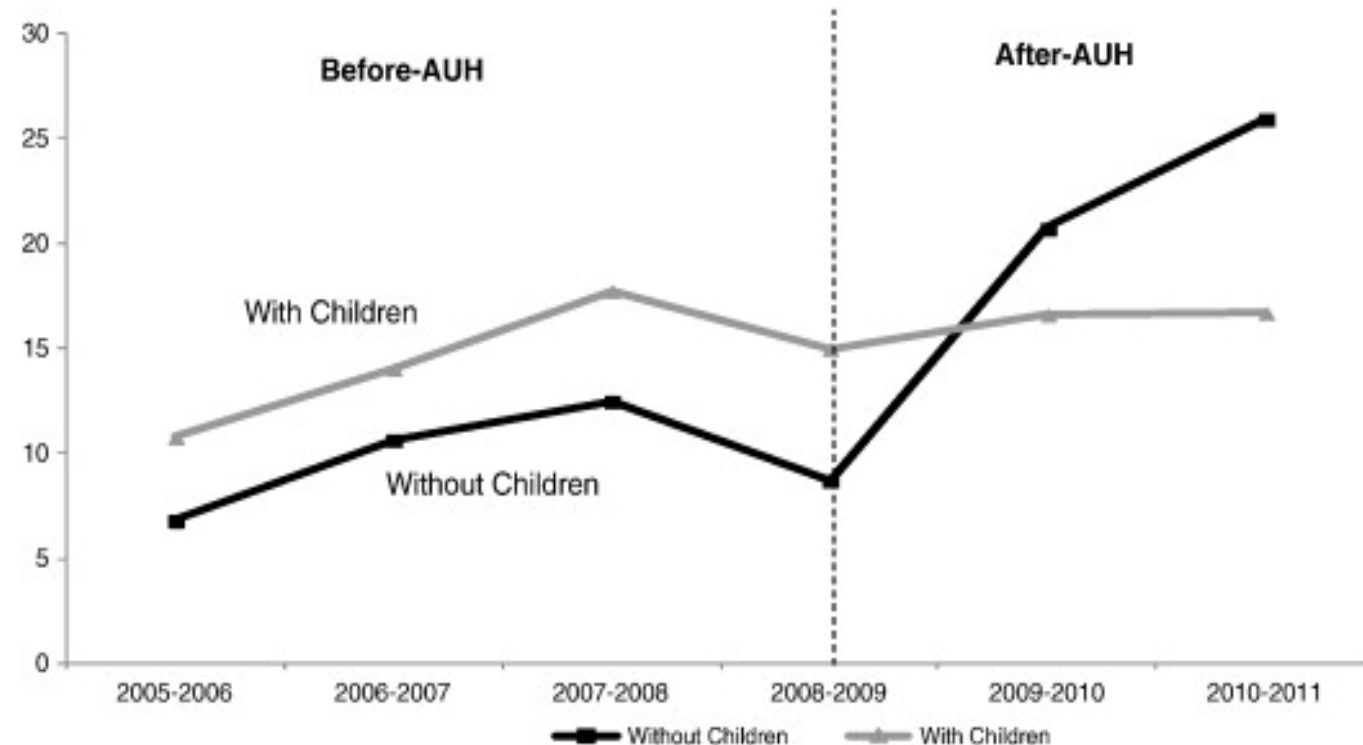


The probability of formal employment fell by 8%.

Evidence from NCSI programs, Argentina

Effects on labor informality of extending child allowances (AUH) to informal workers

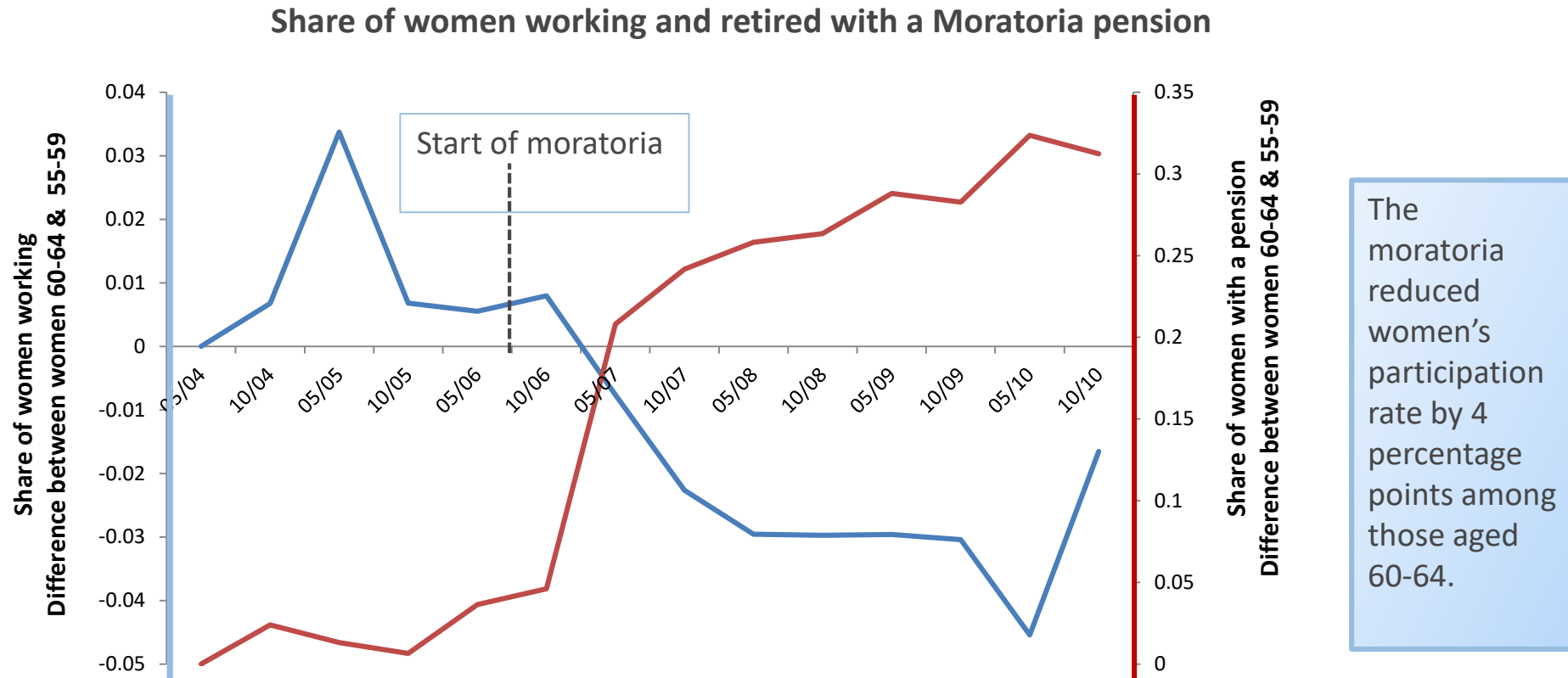
(% of informal workers that become formal)



The extension of child allowances to informal workers reduced substantially the rates at which these workers entered formal employment.

Source: Garganta & Gasparini (2015)

Evidence from NCSI programs, Argentina

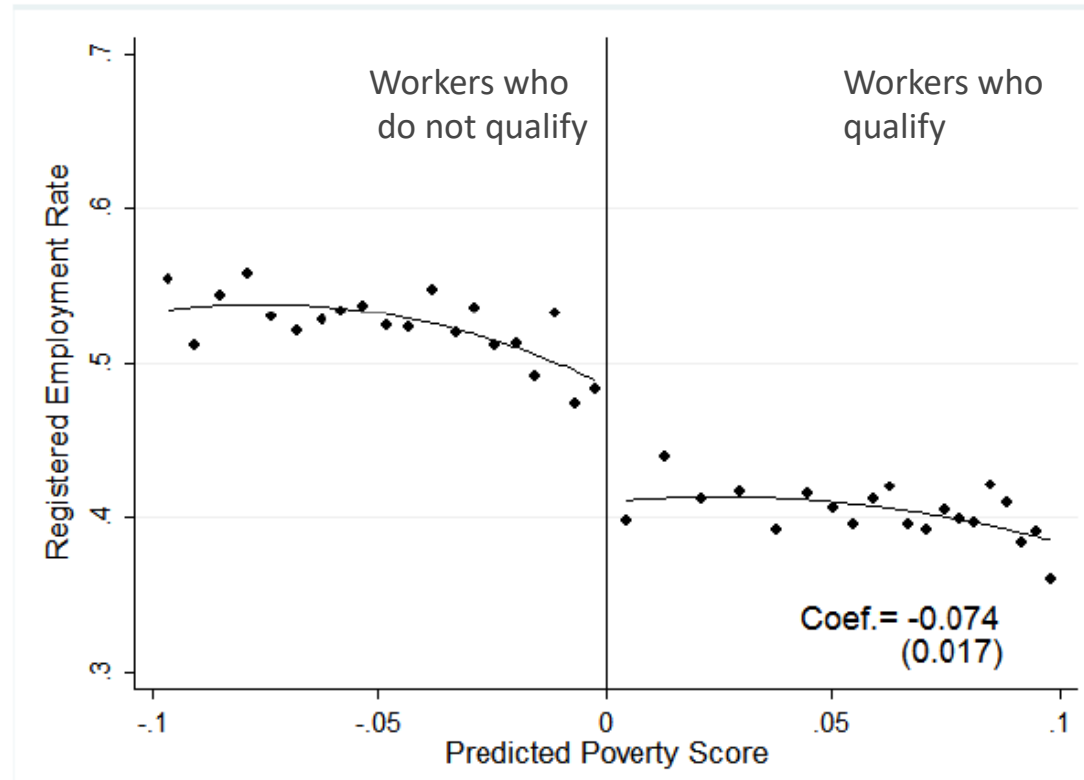


The moratoria gave women over 60 access to a pension without having made any contributions to social insurance, or with incomplete contributions.

Evidence from NCSI programs, Uruguay

Effects on labor informality of family allowances (AFAM)

Figure 2: Effect of AFAM on Registered Employment (Average 2008-2012)



Extending family allowances to poor informal workers reduced formal employment by 7.5 percentage points, from 48 to 41.5 percent.

Source: Garganta & Gasparini (2015)


Methodological observation

- Countries operate **many NCSI programs in parallel**. Further, NCSI programs co-exist with CSI programs.
- What matters is the **combined effect** of all CSI and all NCSI programs, i.e., the combined effect of the tax on formal labor **and** the subsidy to informal labor.
- Few papers look at the full impact of [CSI + NCSI], as it is almost impossible to do so with standard econometric techniques that allow proper identification; that is,

we want to know:

but most papers (like the examples above) measure individual program j:

$$\frac{dL_f}{d(T^{CSI} + T^{NCSI})}$$

vectors 

$$\partial L_f / \partial T_j^{CSI}$$

or

$$\partial L_f / \partial T_j^{NCSI}$$

- Anton, Hernandez and Levy (2012) simulate the joint effects of [CSI + NCSI] programs in Mexico, and find that they reduce formal employment by 26% and increase informal employment by 45% relative to the equilibrium with $T^{CSI} = T^{NCSI} = 0$.

Implications for productivity of CSI-NCSI dichotomy

- Firms and workers respond to the asymmetry in the regulation of labor implicit in the CSI-NCSI dichotomy. These responses depend on:
 - **for firms**, differences in expected costs of a salaried vs. non-salaried contract, possibilities of substitution between them, possibilities of evading regulations on salaried labor (enforcement and fines)
 - **for workers**, the expected utility of each contract (earnings, social benefits, other dimensions of the job).
- Given all other taxes, credit regulations, and so on, these responses impact:
 - the type and size distribution of firms: w/wo salaried contracts, legal/illegal, family firm, one-person firm
 - the efficacy of social insurance (who is covered against what risks, and how often)
 - the fiscal costs of social insurance
 - investments in labor training, adoption of technology and innovation, rotation of workers, tenure, etc.

Structure of labor contracts under the CSI-NCSI dichotomy

Contrat	Expected cost to firm	Expected benefit to worker	Implicit tax or subsidy	
Legal salaried	$w_f + T^{CSI}$	$w_f + \beta^{CSI} T^{CSI}$	$(1 - \beta^{CSI}) T^{CSI}$	Formal employment
Illegal salaried	$w_i + \lambda(.)F$	$w_i + \beta^{NCSI} T^{NCSI}$	$\lambda(.)F - \beta^{NCSI} T^{NCSI}$	
Non-salaried	w_i	$w_i + \beta^{NCSI} T^{NCSI}$	$-\beta^{NCSI} T^{NCSI}$	Informal employment

T^{CSI} = monetary cost of the bundle of contributory social insurance benefits (including contingent costs)

T^{NCSI} = monetary value of all non-contributory social insurance programs

$\beta^{CSI} T^{CSI}$ = worker's valuation of T^{CSI} ; $\beta^{NCSI} T^{NCSI}$ = worker's valuation of T^{NCSI} .

$\lambda(.)F$ = expected penalty for violating a salaried contract (usually increasing in firm size).

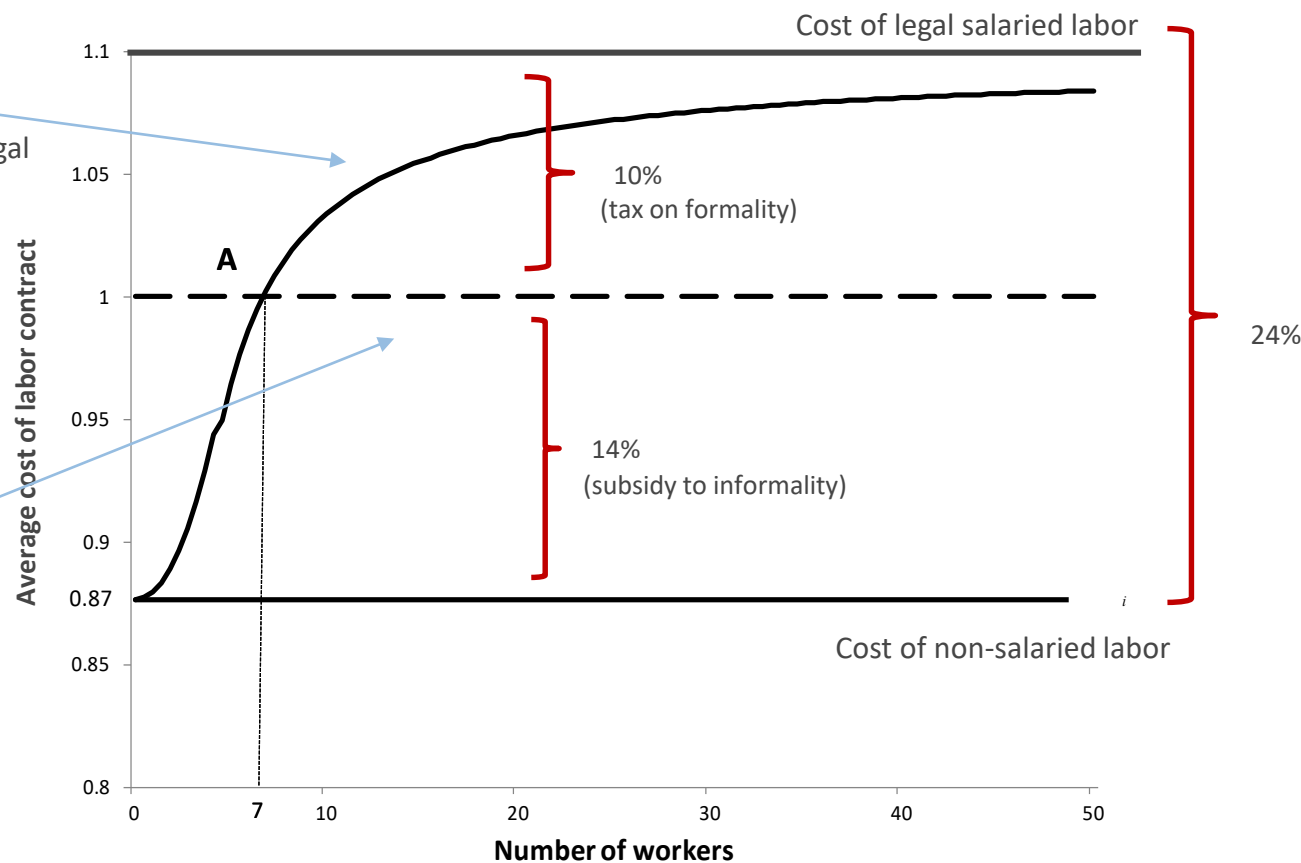
Note: informal employment has a legal and an illegal segment. Under perfect enforcement, $\lambda(.) = 1$, its illegal segment would disappear as long as $F > T^{CSI}$.

Two distortions : *firm type* and *firm size*

Costs of Labor in Mexico

Cost of labor to firms that evade: profit maximizing combination of legal and illegal salaried contracts, given imperfect enforcement.

Cost of labor without the formal – informal dichotomy



- All firms with non-salaried contracts regardless of size subsidized;
- All cheating firms with up to 7 salaried workers subsidized;
- Firms with 8 or more salaried workers taxed, increasing with size.

Mexico, Firms and Resources, 2013

	TYPE	SIZE (# of workers)
FIRMS	73% informal & legal 17% informal & illegal 10% formal	91% 1 – 5 8% 6 – 50 1% 51 +
WORKERS	40% informal & legal 16% informal & illegal 44% formal	40% 1 – 5 23% 6 – 50 37% 51 +
CAPITAL	33% informal & legal 9% informal & illegal 58% formal	19% 1 – 5 22% 6 – 50 59% 51 +

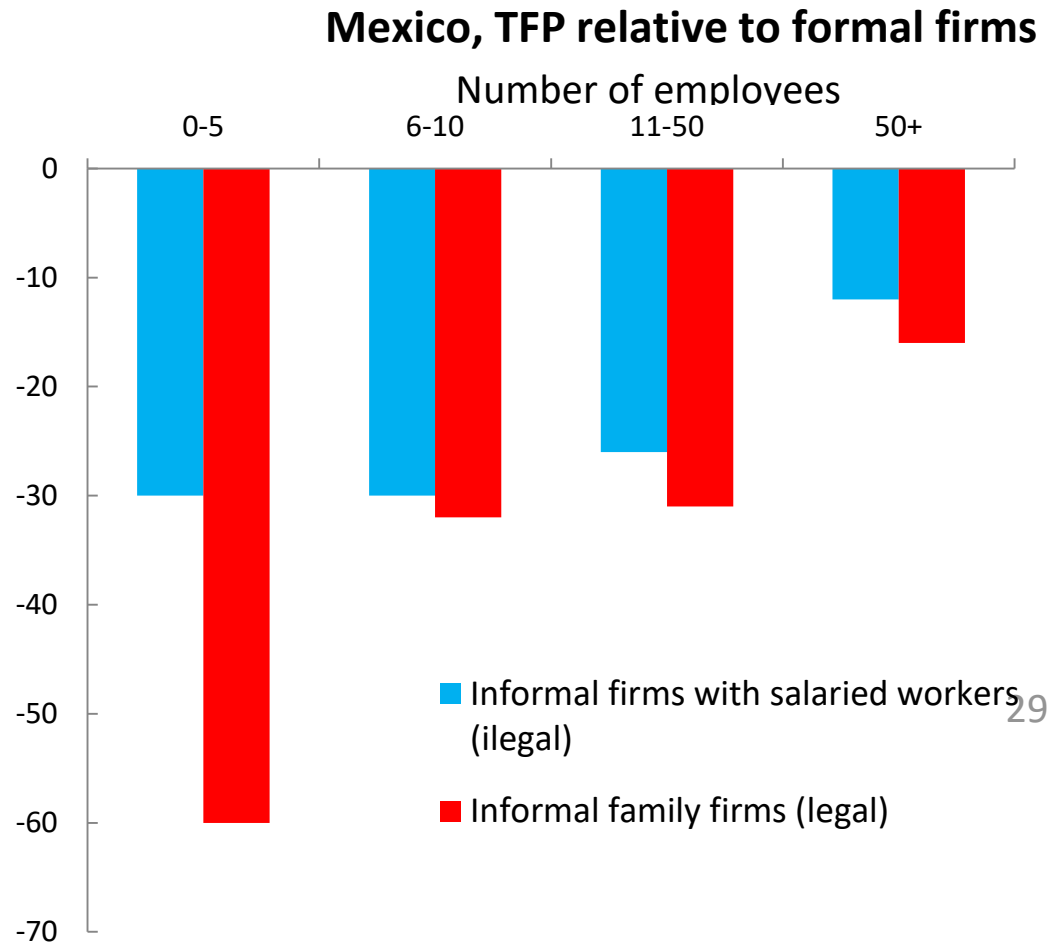
Average firm size = 4.2 (but 3.7 considering firms in mobile premises).

All: 90% of firms; 56% of labor; 42% of capital.

Informality

Legal segment largest: 73% of firms; 40% of labor; 33% of capital.

Informal firms are less productive than formal ones

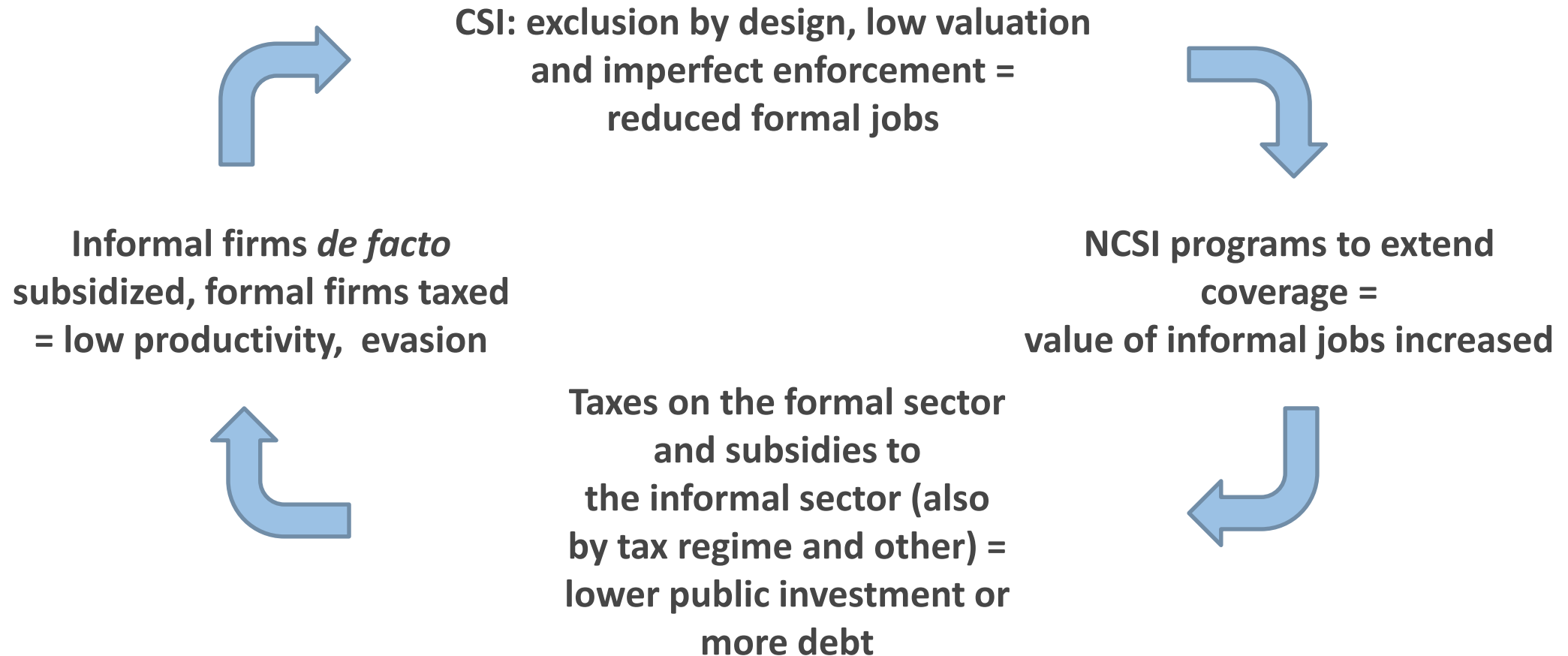


Comparisons of firm-level TFP for a universe of 3.6 million firms

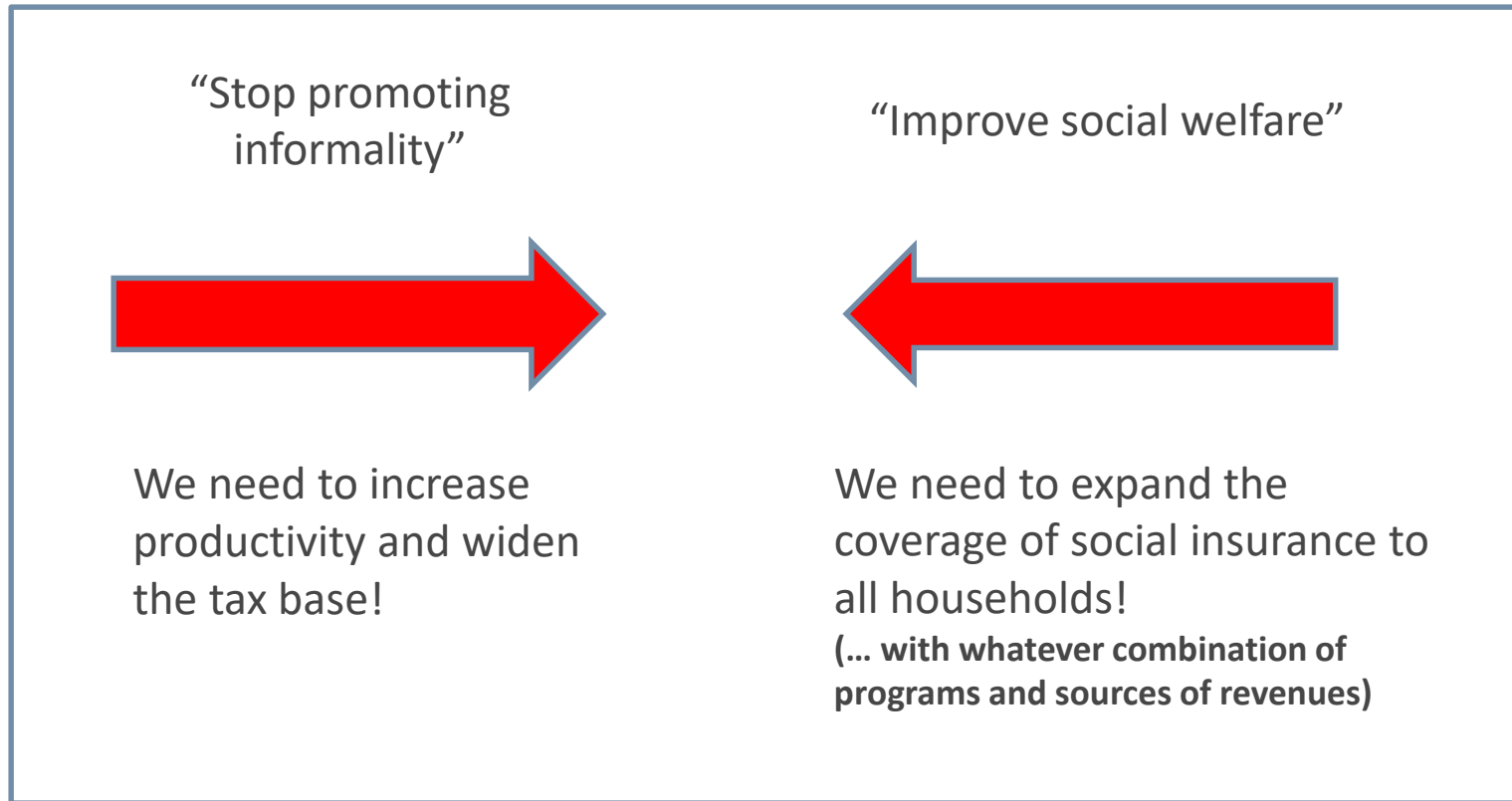
Other factors like the tax regime and credit issues also contribute to these results.

But the wedges in the cost of labor associated with the CSI-NCSI dichotomy play a central role.

The current architecture of social insurance may create a vicious circle between informality and low productivity



The policy problem



The nature of this trade-off varies from country to country and program to program, and while more research is needed, it is clear that a dual social insurance architecture can hurt productivity and growth.

In sum

- Formal/informal segmentation of labor markets in LA very much associated with the dual architecture of social insurance (initially only CSI and more recently NCSI programs). **Social exclusion inherent to the design of social insurance.**
- The CSI/NCSI divide is worrisome: **the same person**, with the same education, sometimes has access to some benefits and sometimes not. Along critical social dimensions (access to life insurance, obligation to save, quality of health care), he/she is treated differently, sometimes for reasons beyond his/her control.
- The CSI/NCSI divide is also worrisome, as it reduces productivity and deteriorates the quality of jobs. **Workers lose doubly.**
- Finally, the current system forces the government to face sharp trade-offs.

The case for universal social insurance - 1

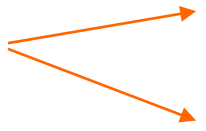
- Most governments recognize access to basic education as a universal right, and structure the financing and provision accordingly.
- But in LA that same recognition is not extended to health care, and to protections against related risks like death, disability and longevity.
- In these cases, coverage has evolved in a very ad-hoc manner, resulting in unfair and inefficient outcomes.
- A strong case can be made to treat at least some key elements of social insurance as a social right of all workers, to be provided with the same quality or scope to all, and funded from the same source of revenue (as public education).

The case for universal social insurance - 2

- There are many variants to this proposal, but a guiding principle can be the following:
 - “Risks that are common to all workers –like illness, death, disability and longevity– should be funded from the same source of revenue and provided to all with the same quality/scope, and
 - Risks that are associated with a specific type of labor –like being fired by a boss or insufficient safety in the workplace– should be funded from a source of revenue specific to that type of labor”
- This principle needs to be adapted to specific country circumstances, calibrated given fiscal space, and so on. But it would provide a compass for the re-design of social insurance in ways that would make it more inclusive, more effective, and friendlier to productivity.

3. Social assistance

Will CCTs break the intergenerational transmission of poverty ?

Two conditions:  more human capital
better income opportunities, especially more productive jobs

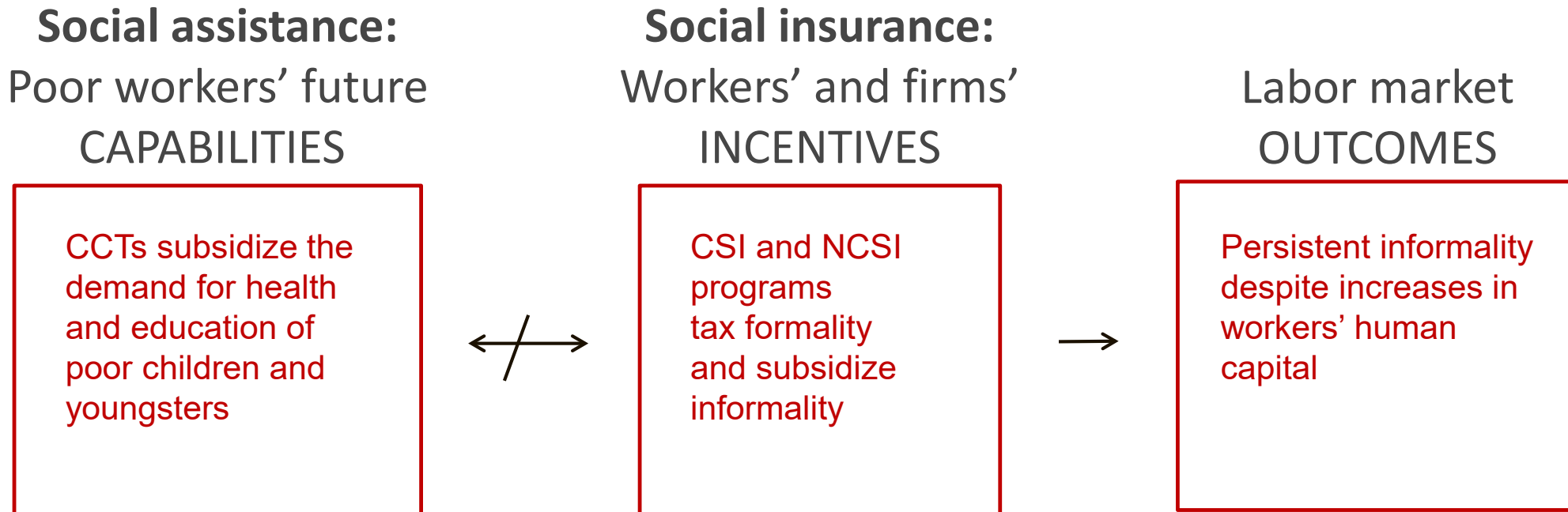
- Unless the poor obtain higher earnings with their own efforts, CCTs run the risk of being a **permanent** scheme to transfer income to the poor, rather than a **temporary** investment in their human capital.
- **CCTs are not:**
 - “job-creating programs”,
 - programs to respond to temporary shocks in output
 - substitutes for social insurance programs.

		Objective: Insurance against risks	
		Formal	Informal
Objective: Redistribution	Non-Poor		
	Poor		

CCTs redistribute while investing in human capital.

This is a “row” issue, not a “column” issue.

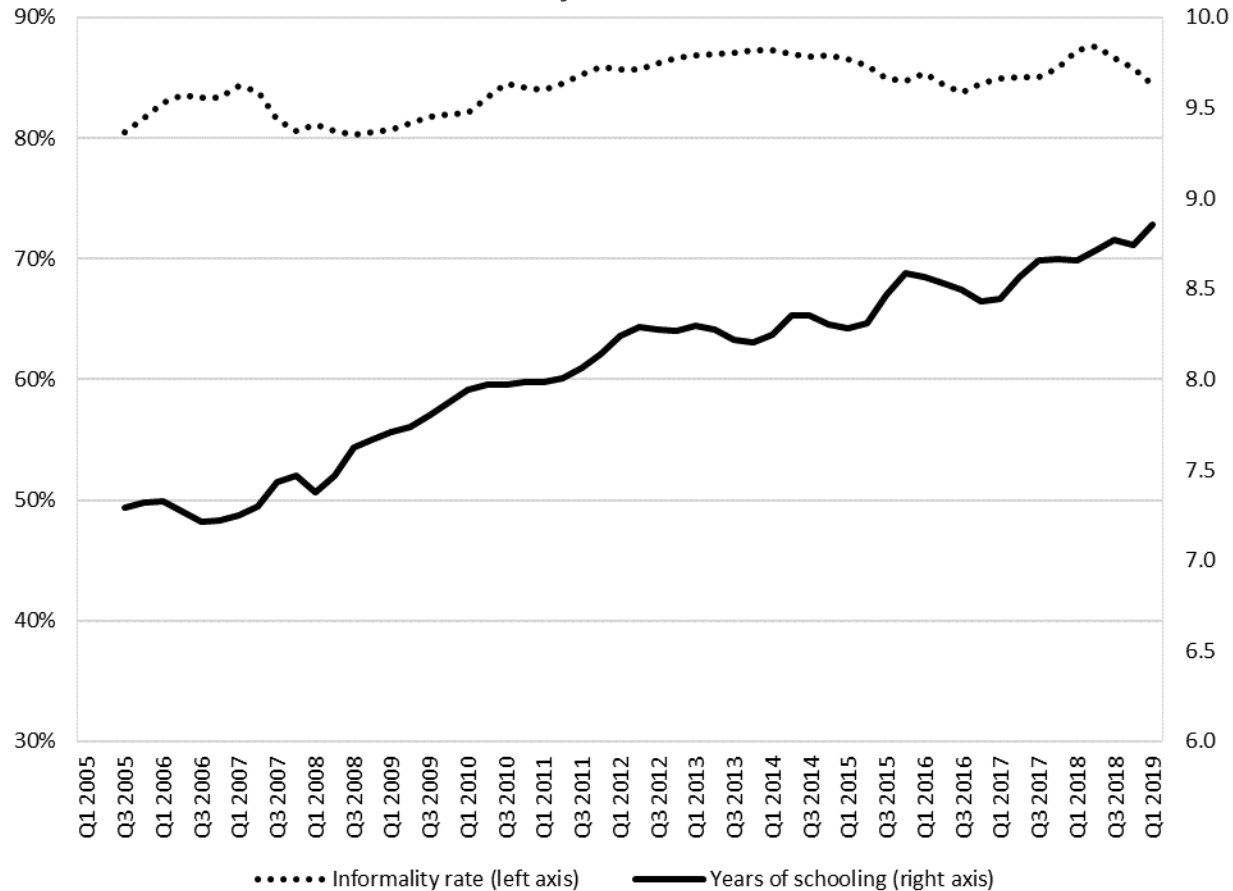
Incentive incompatibility between social insurance and social assistance



- CCTs cannot solve the problems created in the labor market by the formal-informal dichotomy.
- Mexico's CCT (Progresa-Oportunidades) costs about 0.5% of GDP.
- However, Mexico channels 2% of GDP to NCSI programs.

Labor market outcomes for the poor are disappointing

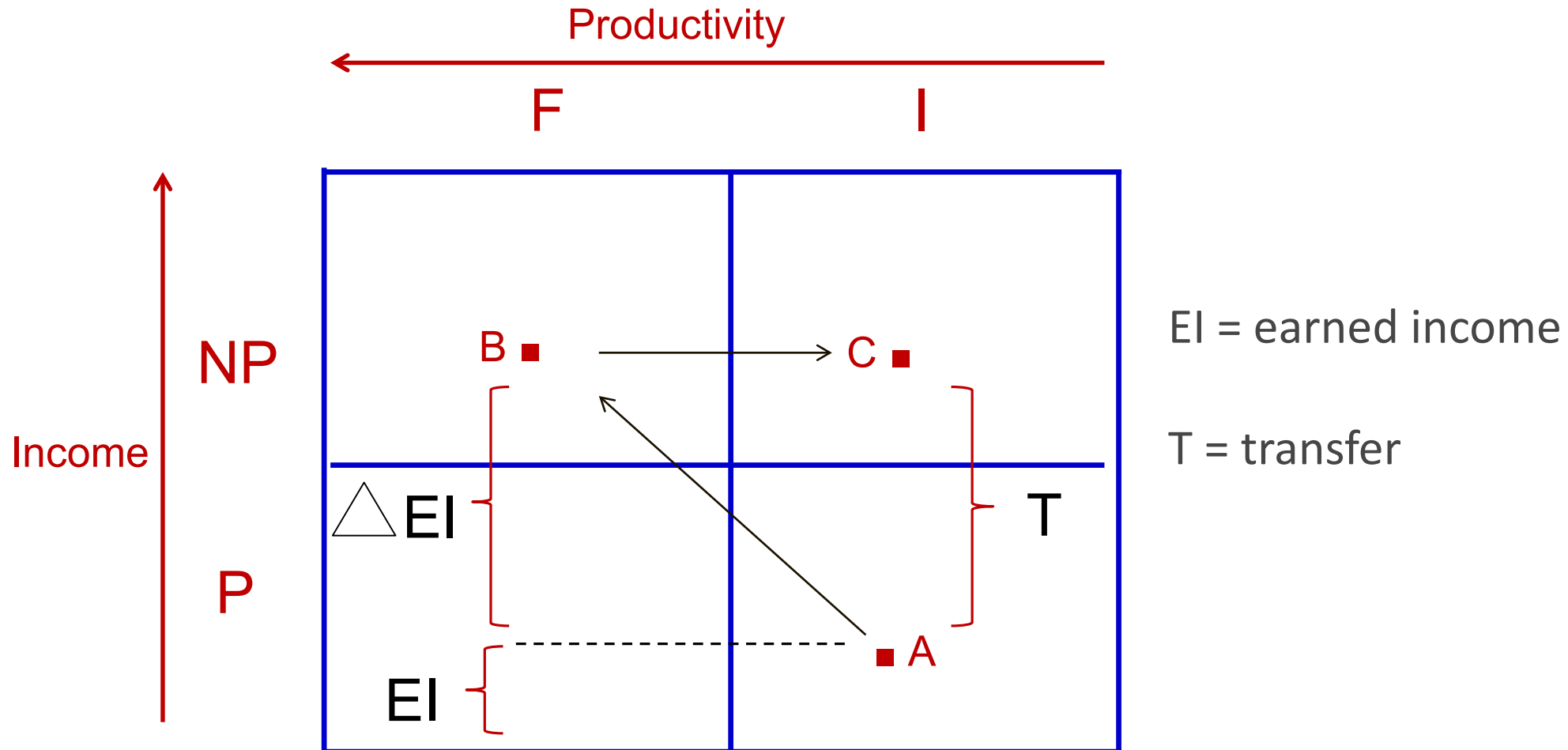
Mexico, 2005-2019



Coverage of CSI is very low, and has fallen slightly, despite increases in years of schooling!

Workers in first two deciles of the earnings distribution working 20 hours or more, aged 20 to 65 in urban areas (15,000 people or more).

A simplified but useful perspective



Young poor workers may be healthier and more educated than their parents as a result of CCT's but they will not access better jobs.

4. Concluding remarks

Social insurance

- The combination of CSI and NCSI is bad social policy (lowers the efficacy of insurance) and bad economic policy (hurts productivity and the tax base).
- Countries need to escape from the dilemmas created by the CSI-NCSI dichotomy. **There are strong equity and efficiency reasons for “universalism”.**
- This is a tall order, as it inevitably involves tackling fiscal issues (what revenue sources should replace CSI contributions?) and challenging long-held paradigms (don't CSI contributions redistribute income from “capital” to “labor”?).

Social assistance/poverty

- Income transfer programs for the poor (like CCTs) should focus on transferring income while investing in human capital; nothing else.
- In parallel, poor workers should be protected against risks through the same mechanisms as all other workers (i.e., by the same social insurance programs).
- A well-functioning labor market is essential for the poor, and this should not be substituted for by other programs (micro-credit?).
- Consequently, a well-functioning social insurance system is part of a strategy to combat poverty.
- More or better NCSI programs for the poor give with one hand, and take away with the other.

Social protection

- It is essential to make a distinction between social insurance and social assistance/poverty programs. We need a clear view of the objectives of each program, the instruments used to pursue them, and the target population.
- Universalism and targeting can and should co-exist.
- Extending coverage and improving quality are key objectives for those concerned with social protection in developing countries.
- LA's experience shows that it is central to consider the **incentives implicit in social programs**:
 - Who qualifies for what?
 - Who pays for what?
 - How do firms and workers react to those rules, differences in revenue sources and in quality of services?

- Debate centers on “architecture” of social protection, not on individual programs.
- Need to go beyond the usual impact evaluation of individual programs and understand how programs interact. Reforms of individual programs, or creation of new ones, can be risky without a systemic view.



(The individual pieces of a watch might be very pretty, but they need to all fit together if the watch is to give the correct time.)

- These issues need urgent attention. Countries may be constructing Welfare States in economies characterized by permanent informality, weak fiscal basis and low productivity growth.

“The ideas of economists and political philosophers, ,are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.

I am sure the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas.... But it is ideas, not vested interests, which are dangerous for good or evil”.

J.M. Keynes, **The General Theory**

In matters of social protection, it may well be the opposite: it is economists who are the slaves of a defunct politician.



Thank you



SANTIAGO LEVY

Informality

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