

Informality, Social Insurance and Pensions

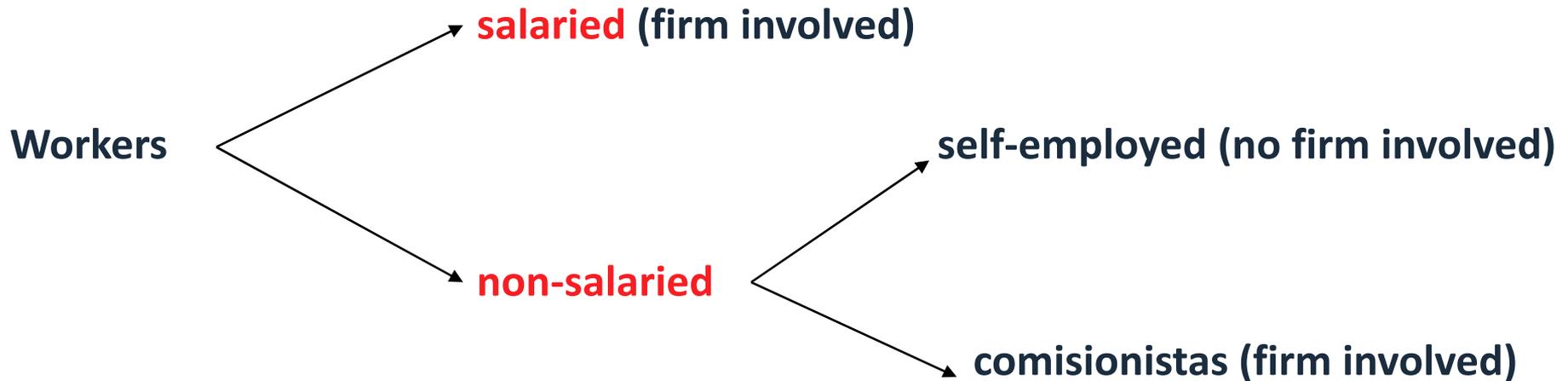
WB Seminar on Pension Systems

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Inter-American Development Bank

The “Truncated” Welfare State

In many countries in LA, social insurance is associated with labor status



Salaried workers have a boss/firm and are paid a wage; there is a relationship of subordination. They have a right to contributory social insurance (CSI).

Non-salaried workers are self-employed, or have non-subordinated relationships with firms: contracts to elicit effort or share risk, with commissions, profit-sharing or other pay structures. They receive various benefits under the rubric of non-contributory social insurance (NCSI).

CSI and NCSI are not the same:

CSI: Benefits are **bundled and obligatory**. Its costs per worker are:

T_f = [health insurance \oplus retirement pensions \oplus disability pensions \oplus life insurance \oplus work-risk pensions \oplus day care centers \oplus housing loans \oplus contingent costs of severance pay \oplus transaction costs of compliance].

Workers' valuations depend on preferences, access and quality of services, and so on. The **utility** of a salaried job is:

$$U_f = w_f (1 + \beta_f T_f)$$

NCSI: Benefits are **unbundled and voluntary**. Its costs per worker are:

T_i = [health + retirement pensions + day care + housing]

The **utility** of a non-salaried job is: $U_i = w_i + \beta_i T_i$

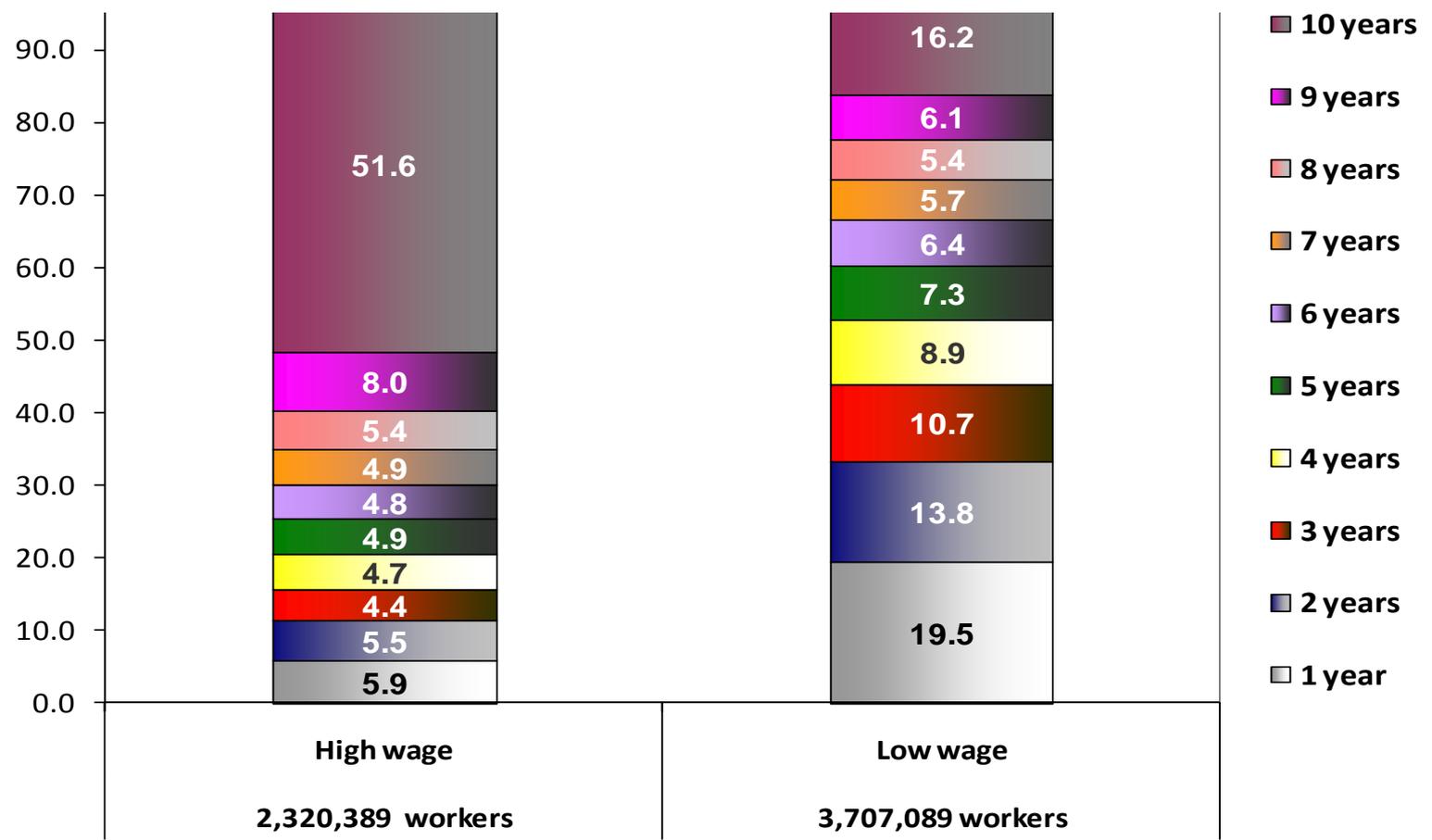
NOTE: Poverty programs \neq NCSI programs

Valuation of CSI and NCSI

- T_f is a bundle: workers need to value all of it at the same time. Its valuation is key as it determines the implicit tax on salaried labor.
- T_i is unbundled; its size and valuation determines the implicit subsidy to non-salaried labor.
- Research shows that workers do not fully value the retirement component of T_f because of information problems (financial literacy), high discount rates, trust and other reasons (Nopo and Pages, 2009).
- Voluntary contributions into workers retirement accounts are practically non-existent (in Mexico, less than 1% of accumulated savings).

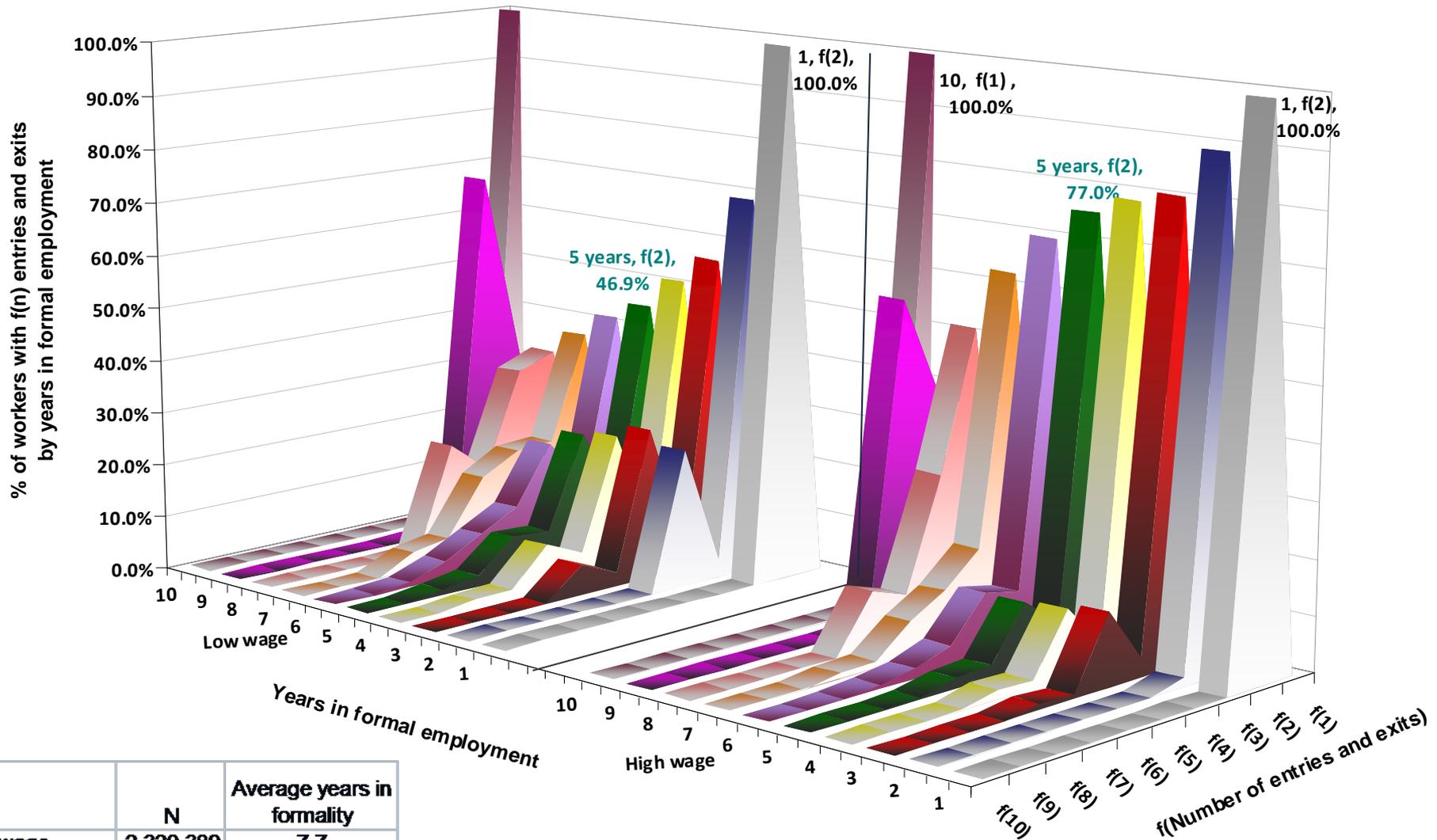
Workers Mobility in the Labor Market

1997 generation: average permanence during 10 years



On average, high (**low**) wage workers who were enrolled in IMSS in 1997 have been in formality 77% (**49%**) of their time.

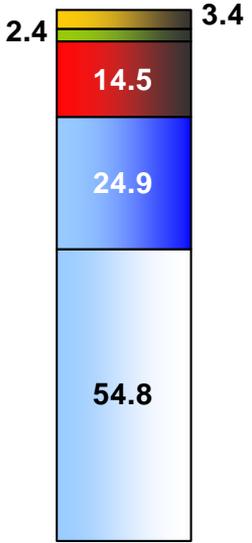
Distribution of workers by years in formal employment and frequency of entry and exit into formality, 1997-2006



	N	Average years in formality
High wage	2,320,389	7.7
Low wage	3,707,089	4.9

Employment surveys*: around 20% of all workers change status in one year

Status in 2006 of 2005 formal low wage workers

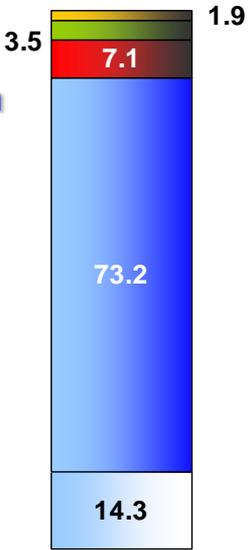


Status in 2006 of 2005 informal salaried workers



	2005	2006
Formal low wage	15.4	14.9
Formal high wage	19.2	21.0
Informal salaried	32.1	32.3
Informal self-employed	26.1	26.0
Open Unemployed	7.2	5.9
Total	100.0	100.0

Status in 2006 of 2005 formal high wage workers



Status in 2006 of 2005 openly unemployed



*Workers 16-65 who did not change location, and were continuously interviewed from 2005 II to 2006 II.

Two key empirical results:

1. Low wage workers have **lower average permanence in formality** than high wage workers;
2. Low wage workers have **greater frequency of entry and exit** in formality than high wage.

The problem for low wage workers is not “entering” into a formal job at any wage. The problem is that they have infrequent stays in formality and earn “low” wages.

This contrasts with the “barriers to entry view”, that suggests that workers in the informal sector cannot get formal jobs at any wage. **But regardless of the cause (exit vs. exclusion), the key point is that there is large transit from formal to informal status and vice-versa.**

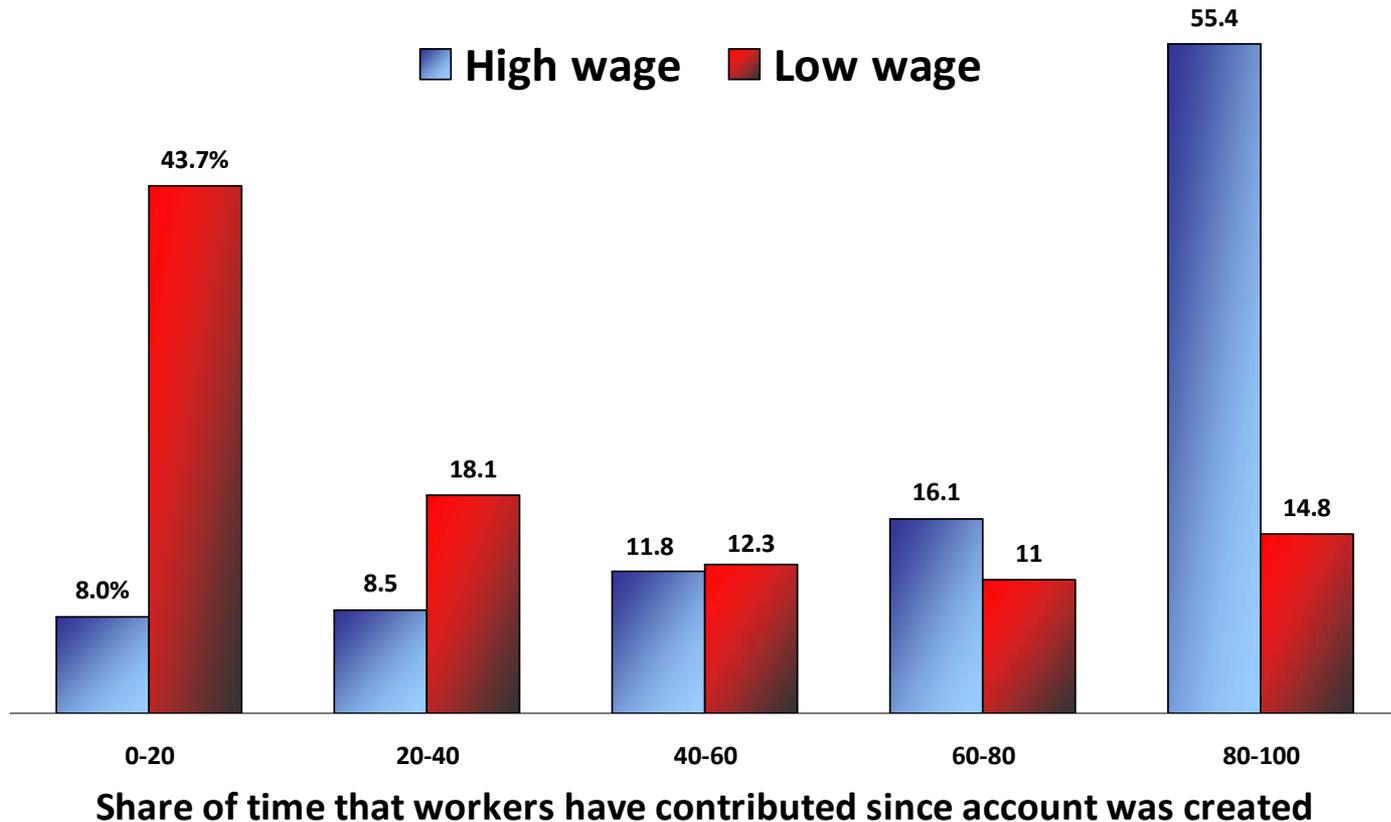
Implications for social insurance

- Distinction between “formal worker” vs. “worker at present hired formally”. Most workers have spells of formal and informal employment.

[There is (almost) no such thing as a formal worker].

- Some firms hire formal and informal workers simultaneously.
- Only when workers are formal do they consume the bundle that the government wants (health, life and disability insurance, save for retirement, severance pay).
- Coverage against risks erratic and incomplete: when formal yes, when informal, partially (given unbundled nature of social protection programs).

Implications for retirement pensions



Data from 37.8 million individual retirement accounts, of which 79% are low wage and 21% high wage.

The average contribution density in the 1997-2007 period was 45%. Replacement rates will be low, particularly for low wage workers. **Most low wage workers will not qualify for the guaranteed minimum pension (at least 25 years of contribution).**

What are the Policy Options?

Policy needs to begin by recognizing that the government is trapped

- The institutional distinction between the rights of salaried and non-salaried workers **creates a formal-informal dichotomy**;
- From the social point of view, the government cannot leave workers excluded from social security without protection against social risks;
- However, NCSI does not really solve the social problem (because of the unbundled nature of programs), while at the same time deepen the reasons that account for **bad firms and bad jobs, low productivity and low growth**;
- In parallel, the government *de facto* subsidizes illegal behavior, and **undermines the tax base and the Rule of Law** (as illegally hired salaried workers cannot be left without social benefits).

The policy challenge has two parts:

- From the **social point of view**, to insure that all workers are protected all the time against the relevant social risks regardless of whether they are salaried or non-salaried;
- From the **economic point of view**, to provide benefits with programs that by-pass the distortions in the allocation of labor and capital and avoid undermining the tax base.

**It is essential to focus on both objectives
SIMULTANEOUSLY.**

Proposal for universal social insurance

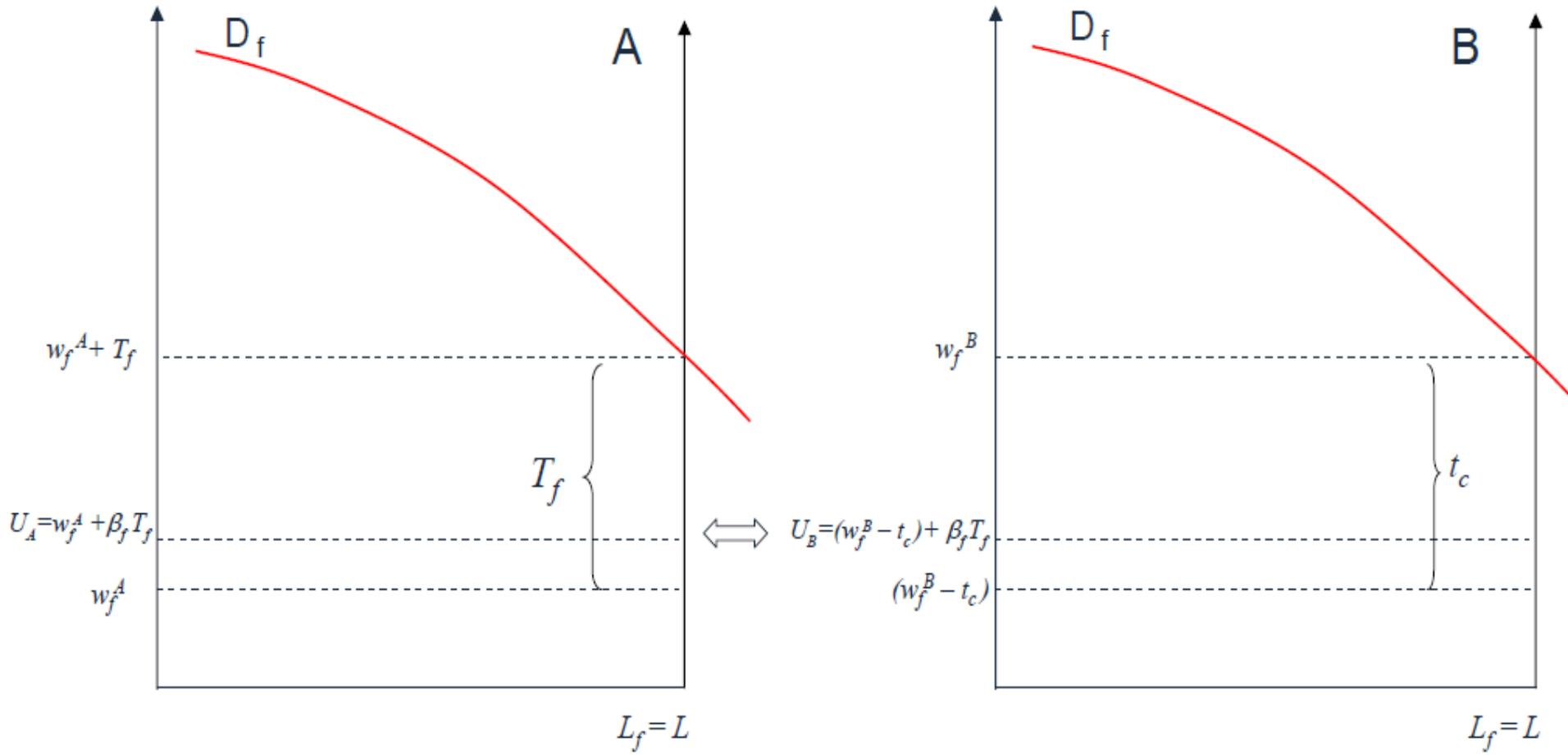
Simple idea: provide all workers with (almost) the same bundle of social insurance; make these benefits a legal entitlements; and fund all these benefits with a consumption tax earmarked for these benefits.

Key point: Firms and workers cannot avoid this tax by changing status between salaried and non-salaried employment, so:

- no taxes on firm growth;
- no subsidies to self-employment;
- no subsidies to small illegal firms;
- no reasons to change the duration of labor contracts or disguise salaried employment relationships as non-salaried;
- distortions in the allocation of capital and labor coming from social programs are (practically) eliminated.

Observation: The result would be the same as if all workers were salaried and CSI was fully enforced. But since there are efficient reasons for non-salaried employment, and enforcement of CSI will never be perfect, universal social insurance will never be reached under the formal-informal dichotomy.

Social security contributions (A) vs. consumption taxes (B)



If all workers were salaried, and **if** there was no evasion, and **if** consumption taxes could be ear-marked to pay for social security benefits, then social security contributions and consumption taxes would be equivalent.

Social insurance: CSI + NCSI vs. USI

CSI + NCSI

$$T_f = [\dots \oplus \dots \oplus \dots \oplus \dots \oplus \dots]$$

$$T_i = [\dots + \dots + \dots]$$

$$\partial Q_f / \partial L_f - [w_f + (1 - \theta_f)T_f] = 0$$

$$\partial Q_f / \partial L_{if} - [w_{if} + \lambda F + \lambda' FL_{if}] = 0$$

$$\partial Q_i / \partial L_i - w_i = 0$$

$$w_f + \beta_f T_f = w_{if} + \beta_i T_i = w_i + \beta_i T_i$$

$$L_f + L_{if} + L_i = L$$

$$G_{os} + [\theta_f T_f L_f + T_i (L_{if} + L_i)] = R_c + R_\pi + OR$$

USI

$$T^* = [\dots \oplus \dots \oplus \dots]$$

$$\partial Q_f / \partial L_f - w_f = 0$$

$$\partial Q_i / \partial L_i - w_i = 0$$

$$w_f + \beta T^* = w_i + \beta T^*$$

$$L_f + L_i = L$$

$$G_{os} + T^* (L_f + L_i) = R_c^* + R_c + R_\pi + OR$$

T^* is the bundle of social insurance benefits that the government considers that all workers should have and β is worker's valuation of that bundle; R_c^* reflects those consumption taxes that are specifically earmarked to pay for universal social insurance that result from higher consumption tax rates, so that: $T^*(L_f + L_i) = R_c^*$.

Full de-linking and un-bundling is not desirable

Structure of benefits

T^* = [health insurance \oplus retirement pensions
 \oplus life insurance \oplus disability insurance]

T_f^* = [work-risk insurance \oplus unemployment
insurance (+?) retirement pensions]

Observations

Bundled protection for all workers for these risks

Salaried workers get additional protection for risks specific to salaried work (and more pensions?)

Labor Market

$$\partial Q_f / \partial L_f - (w_f + T_f^*) = 0$$

$$\partial Q_i / \partial L_i - w_i = 0$$

$$w_f + \beta T^* + \beta_f^* T_f^* = w_i + \beta T^*$$

Firms hiring salaried workers pay for T_f^*

Non-salaried workers do not get T_f^*

Wage-based benefits distort only if $\beta_f^* < 1$; note that T_f^* contains only monetary benefits, so $\beta_f^* \approx 1$

Note: This scheme allows for a two-pillar retirement pension system (only when workers are salaried-employed), by including a retirement pension component in T_f^* .

Role for voluntary savings and MDCs

- A two-pillar system of savings could help increase retirement pensions, but the additional forced savings would only occur when workers are salaried employed.
- It is difficult to tell what salaried/non-salaried transits would be under universal social insurance, but even if transits are reduced, there would be an important segment of the labor force that is not salaried employed.
- MDC's can be a useful complement to USI to induce everybody to save more, and provide for more consumption smoothing.
- Research is needed to determine the structure of incentives of MDC's, but it is key that they do not distort incentives for salaried vs. non-salaried work.

Thank you!