

Botero, Rodrigo; Cavallo, Domingo; Khan, Amir Ullah; Thiele, Rainer; Wiebelt, Manfred

## Conference Paper

# Escaping the informal-employment trap in developing countries

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## The Global Economy

# Escaping the Informal-Employment Trap in Developing Countries

### The Challenges

Informality is a way of life throughout the developing world. In poor Sub-Saharan African countries, the informal sector employs the vast majority of the non-agricultural labor force. Informal jobs continue to account for a high share of employment in the middle-income Latin American countries, pointing to the persistence of the phenomenon.

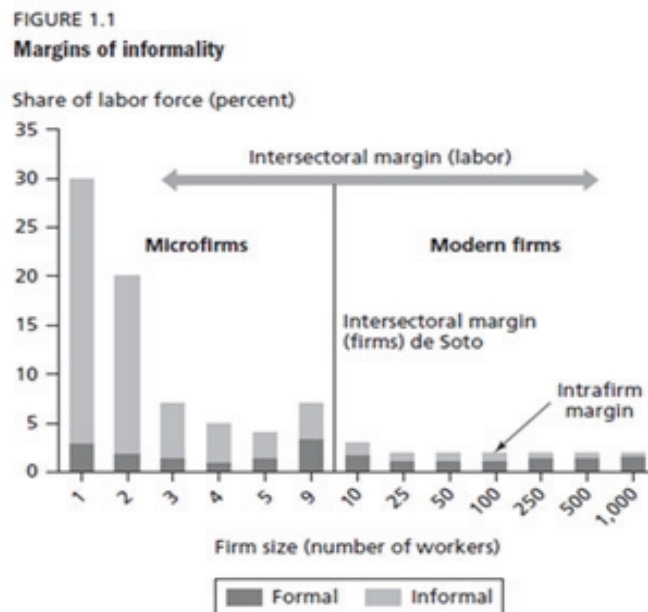


The current economic crisis is likely to cause a further surge of informal employment due to job losses in the formal sector.

Even though informality appears in many different guises, informal workers tend to have in common that they earn less than formal workers and that their basic rights are more vulnerable and difficult to defend. Informality can be a major cause of poverty as most informal workers are insufficiently protected from illness and health problems, unsafe working conditions and possible loss of earnings due to sudden dismissal.

Persistently high levels of informal employment also reduce fiscal revenues and the state's capability to develop social security systems.

When it comes to devising strategies that help overcome the informal-employment trap, a number of questions arise. Should formalization always be the ultimate objective, or are measures that raise the productivity of informal workers and provide them with basic social protection equally important? Do high labor costs and restrictions in the formal labor market constitute insurmountable entry barriers, suggesting a need for labor market reforms? Does the tax system give rise to widespread tax evasion? Could more secure property rights lead to a pathway out of poverty for informal entrepreneurs?



Source: Maloney 2006.



## **Proposed Solutions**

### **Rodrigo Botero**

### **Domingo Cavallo**

*Chairman and CEO, DFC Associates LLC; Member of G30*

### **Incentives to formal employment: A proposal for Colombia**

The creation of formal employment is currently the main challenge of economic policy in Colombia. The year 2010 began with unemployment in the double digits and high rates of underemployment and informal employment, which disproportionately affects young people and those with low educational levels.

The current high level of unemployment, underemployment and informal employment in Colombia, rather than a situational phenomenon, is a structural problem. Even during a period of expansive growth, from 2003 to 2007, the unemployment rate remained in the double digits. The 2.5% GDP growth forecast for 2010 is insufficient to avoid a deterioration of current labor market indicators.

To assure the issue of employment receives the attention it deserves, the massive generation of formal work must become the central objective of the Colombian political economy, not the spin-off of another. That is the change of focus we recommend.

Formal employment creation in Colombia is taxed with social security contributions and payroll taxes that equal roughly 60% of the base salary for each worker. On the one hand the employer considers these contributions as true payroll taxes, and on the other the worker does not view them as deferred wages. It is likely that only the provisions for severance pay, transportation allowance, and wardrobe are perceived by workers as a deferred or in-kind salary.

This high payroll tax is the direct result of a decision made with the best of intentions. However, its effect has been to harm the very persons that were intended to benefit from its implementation. In recent years a series of tax exemptions have been adopted aimed at reducing the cost of capital, with the purpose of stimulating investment.

The combination of taxes that raise the cost of work and tax exemptions that reduce the use of capital create a perverse structure of incentives that distort relative cost factors. Economic agents respond to incentives that support them. If public policies promote the substitution of labor for capital, this causes a suboptimal utilization of production factors that do little to encourage the generation of formal employment.

Our proposal is simply to reverse this incentive scheme: to replace the current investment incentives by formal employment incentives. The viability of our proposal that is presented below requires far-reaching political consensus. It is clear there are obstacles to changing current labor structures. We suggest a strategy that overcomes them by maintaining contributions to entities that benefit from payroll taxes, and financing these transfers with fiscal resources that are set aside for promoting investment.

### ***The fiscal cost of investment incentives***

The Ministry of Finance estimates the fiscal cost of granted tax benefits in relation to income tax. In 2008 the estimated fiscal cost from the deduction of 40% of the investment in fixed real assets rises to 3.8 billion pesos. Assuming that the cost is proportional to income subjected to



taxes, the 2009 projection of the said cost climbs to 4.4 billion pesos. These numbers can be found in the database prepared by “Marco Fiscal of Mediano Plazo” in 2009.

The same source provides information that compares this fiscal cost with the amount of payroll tax businesses pay. For 2009 the estimate of this amount rises to 3.8 billion pesos. This is a rate of 30.2% over basic wages (21.5% of Social Security and 8.6% plus quasi fiscal taxes of 8.6%). The fiscal cost of the deduction for investment is to 116% of the total payroll tax paid by businesses.

These numbers show the magnitude of the fiscal incentive that could lead to the creation of formal employment, if the current deduction on investment is replaced by deduction on payroll tax generated by those new investments. The replacement of the 40% tax deduction on the income of new investment for a 120% tax reduction on the increase of payroll tax would add to the formal economy roughly the same number of informal and unemployed workers to the number of current workers in formal employment.

### ***The proposal***

Our proposal seeks to transform current investment incentives into incentives that bring about formal employment. We propose the real increase in the Wage Bill paid by each company from a base year as the basis for the formal employment incentive.

To calculate this real increase the Wage Bill for the base year is adjusted by the Consumer Price Index. If the tax benefit became applicable in 2010 the calculation would start from the 2009 wage sum adjusted by the increase of the IPC between 2010 and 2009. For 2011 and the following years, the base will be still the same but with an additional year of adjustment of CPI.

To maintain a five year horizon, once five years have passed since the first time the benefit was applied, the base year will be moved to the next year. This means, if the initial base year was 2009, in 2015 that the base year is moved to 2010, following 2011 in 2016, and so on.

The proposal suggests replacing the current investment credit of 40% from Income Tax, for a fiscal credit of 60% of Payroll Tax paid on the real increase in the Wage Bill.

Moreover, it is proposed that 60% of paid payroll tax for workers in the base year not enrolled in social security, because they were inactive, unemployed, or working informally, will be deductible. In this way, if the real increase of the Wage Bill is produced because the company adds staff that in the base year were not registered in social security, it would reduce its income tax 120% from the real increase in the wage sum.

This incentive is less onerous than the current one. It would be the same only if in 5 years the real increase in the Wage Bill is equal to 97% of the Wage Bill in the base year. This would only occur if after five years nearly all the informal economy and the unemployed would have moved into the formal economy.

### ***Acquired rights***

Firms that have acquired rights to fiscal stability and currently enjoy the 40% investment credit to Income Tax would not be forced to comply with the new scheme proposed here. Resultantly, the change should be applicable from here forward and to all other companies, unless those with acquired rights opt for the new regime. It is impossible to calculate what the fiscal effect would be from the continuity of investment incentives.

The new fiscal credit of 120% of the taxes on the increment of real Wage Bill would be the same than the prior investment incentives when the Wage Bill doubles with respect to the base year. Therefore, it is likely the fiscal cost of the two added benefits, while existing together, would not surpass the cost of the investment credit that would be eliminated.



### ***Effect on the wage cost***

The proposal entails a reduction to the labor cost for all firms in the private sector that generate new formal employment in the order of 24%, if those not incorporated into the formal economy were not registered in social security in the base year. If the new jobs correlate to persons that were working in the formal economy in the base year, the reduction to the labor cost would around 12%.

### ***Fiscal amnesty***

To assure the benefits of this incentive effectively reach businesses that have been operating partially or totally in the informal economy, it would be necessary to grant fiscal amnesty for Payroll Tax, on Value Added Tax and Income Tax that would have been avoided while the worker was a part of the informal economy.

### ***Expected results***

The granting of fiscal incentives attached to increases in Payroll Tax paid by firms should not harm the growth of the economy, because the fiscal incentive granted, as a proportion of value added, is the same. Rather, it should have a positive effect on growth, at least for a period of time, because it should produce efficiency gains due to better allocation of resources.

The effect on employment, at least on formal employment, should be considerable taking into account the reduction of the wage cost for firms lowers significantly, and that businesses will officially receive the benefits from fiscal amnesty towards obligations they have evaded in the past.

The number of firms benefiting from employment incentives would be much greater than the number of firms benefiting from investment incentives. Moreover, the new incentive small and medium businesses that currently are unable to take advantage of investment incentives.

Funds for social security benefits, health, education, and family support that are currently financed with Payroll Tax would benefit with the new incentives due to the increases in tax collection that would be proportional to the increase in formal employment. This is different from the result that would be obtained if instead of changing the basis for granting fiscal incentives, it was decided to decrease the Payroll Tax Rate.

### **Amir Ullah Khan**

*Director Research, Bangalore Management Academy; Fellow, India Development Foundation*

### **Reforming labor law**

The labor market in most developing countries is dualistic and segmented. Formal and informal markets coexist. Transactions continue to be non-monetized. Information is not complete and is costly. Mobility is restricted. In addition to this problem of a vast majority in the unorganized sector, the work force also is remarkably heterogeneous. Laws that protect only the organized sector do not protect the unorganized or the informal sector. Added to this is the problem of the plurality, which results often in conflicting interests and goals. Caste or race factors and regional factors enter into the picture and worker interests get relegated. For example, in India, the labor dispute settlement system is ineffective. Neither conciliation, compulsory adjudication nor arbitration longer provide employees a fair and expeditious method of labor dispute settlement. The resolution of a labor dispute takes about 20 years. Part of the delay is attributable to excessive uncertainty and ambiguity about key legal concepts. This contributes to uncertainty about the rights and obligations of employers and employees and to delays in the dispute settlement process.





Harmonization and unification of labor laws are thus clearly necessary. It is also important to reduce state intervention. One does not necessarily have in mind reduced state intervention in social security type legislation, or perhaps even in wage-related legislation. By reduced state intervention, what is meant is reduced intervention in the area of industrial relations. In India, there are more than 45 Labor laws in operation today. Ideally, there should have been a single code. Measures to improve labor rights, enhancing social protection, investing in knowledge and skills of workers or providing micro-entrepreneurs with access to credit and other support services are all critical thrust areas. The challenge is to tie them up while removing the legal and institutional obstacles that otherwise make this difficult. Reforming labor law is clearly a big move towards making the informal job market flexible in developing countries.

## **Amir Ullah Khan**

*Director Research, Bangalore Management Academy; Fellow, India Development Foundation*

### **Training and skill development**

Despite unprecedented growth in the last decade, India has a very low per capita income. The Indian workforce is around 460 million strong. More than 90 per cent of the workforce is in the unorganized sector and the unemployment rate is around 9 per cent.

Employment surveys report low unemployment rates; the reality is that many Indians work on more than one job and continue to search for other opportunities even when they are already employed in some activity. Low productivity is a major cause for both of these. This disguised unemployed when added to the unemployed results in very high unemployment. To freeze unemployment, India needs 8 million new jobs. Given India's employment elasticity (0.15) and ICOR (3.75), this will require an annual GDP growth rate of 12 per cent and investments of US\$200 billion.

Even among those employed, 140 million or 30 per cent of the people work with no regular jobs. Not only do they earn irregular incomes, the wage rates in these activities are very, very low. Over 70 per cent of the total labor force (organized and unorganized) is illiterate or educated below the primary level.

The supply of unskilled labor is very high, and hence, the wage they can command is very low. On the other hand, the demand for specific skills is very high, and often, unmet. The solution therefore is to ensure that the unorganized labor is skilled. This requires trainers and training infrastructure. Then that the skill is recognized and accepted by the potential employers. This requires credible certification of the skills acquired by labor. An added advantage of certification is that labor markets become integrated.

## **Rainer Thiele**

*Kiel Institute for the World Economy*

## **Manfred Wiebelt**

*Kiel Institute for the World Economy*

Informal employment can be the result of both people being excluded from formal jobs and people voluntarily opting out of formal structures. To deal with these distinct phenomena, a carefully targeted government response is needed.

For the world's poor, working informally is often the only way to participate in the labor market. Poverty-alleviation measures that provide improved risk management and social protection should be employed to address the hardship of these people. At the same time, governments should try to unlock them from their low-productivity activities. Specific options



include active labor market policies, such as training and skill-development programs, which may open the door to formality.

If informal employment is a deliberate choice to avoid taxes or administrative burdens, as is often the case in Latin America, governments should aim to establish efficient formal structures that have the potential to encourage people to join or rejoin the formal sector. In most countries' tax systems, for example, there is scope for reducing administrative costs and increasing collections through changes in tax structure, combining reductions in marginal tax rates with the elimination of exemptions. Lower barriers to the registration of formal businesses and a better alignment of social security contributions and benefits would be other means to raise the attractiveness of the formal sector.

Apart from providing positive incentives, targeting those who voluntarily opt out of the formal sector also requires the establishment of credible enforcement mechanisms so as to increase compliance with a country's rules and regulations. This would include regular labor inspections and tax audits.

While policies can go a long way towards overcoming widespread informal employment, they are no substitute for trust. Informality is above all an expression of a negative perception of the role of the state. Long-term sustainable change therefore requires credible public institutions, such as impartial courts and transparent tax authorities, as well as a transformation of people's attitudes and beliefs. The latter may be facilitated by information campaigns on the benefits of formal work and the risks of informality.