

# Informality in Latin America: Taxes and beyond

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**ELLA Summit on Informality and Inclusive Growth**  
Johannesburg, October 4-5 2016



Lauenburg, 1890



Macondo  
Por Hernando Nossa<sub>3</sub>

# Informality in Latin America: Taxes and beyond

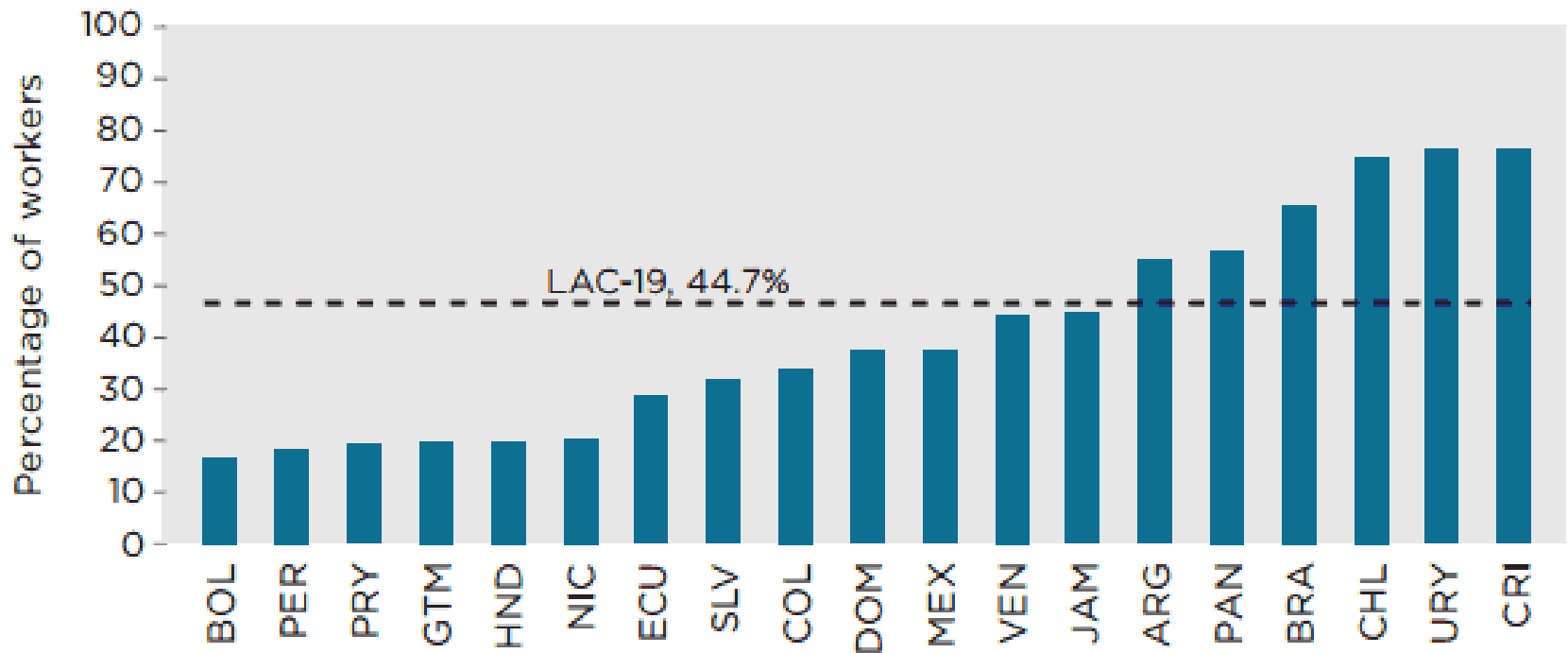
- *Informal is normal* in Latin America
- Taxes and informality: *in it together?*
- Beyond taxes: *a way forward*

# Informality in Latin America: Taxes and beyond

- ***Informal is normal in Latin America***
- Taxes and informality: *in it together?*
- Beyond taxes: *a way forward*

# Informal is normal in Latin America...

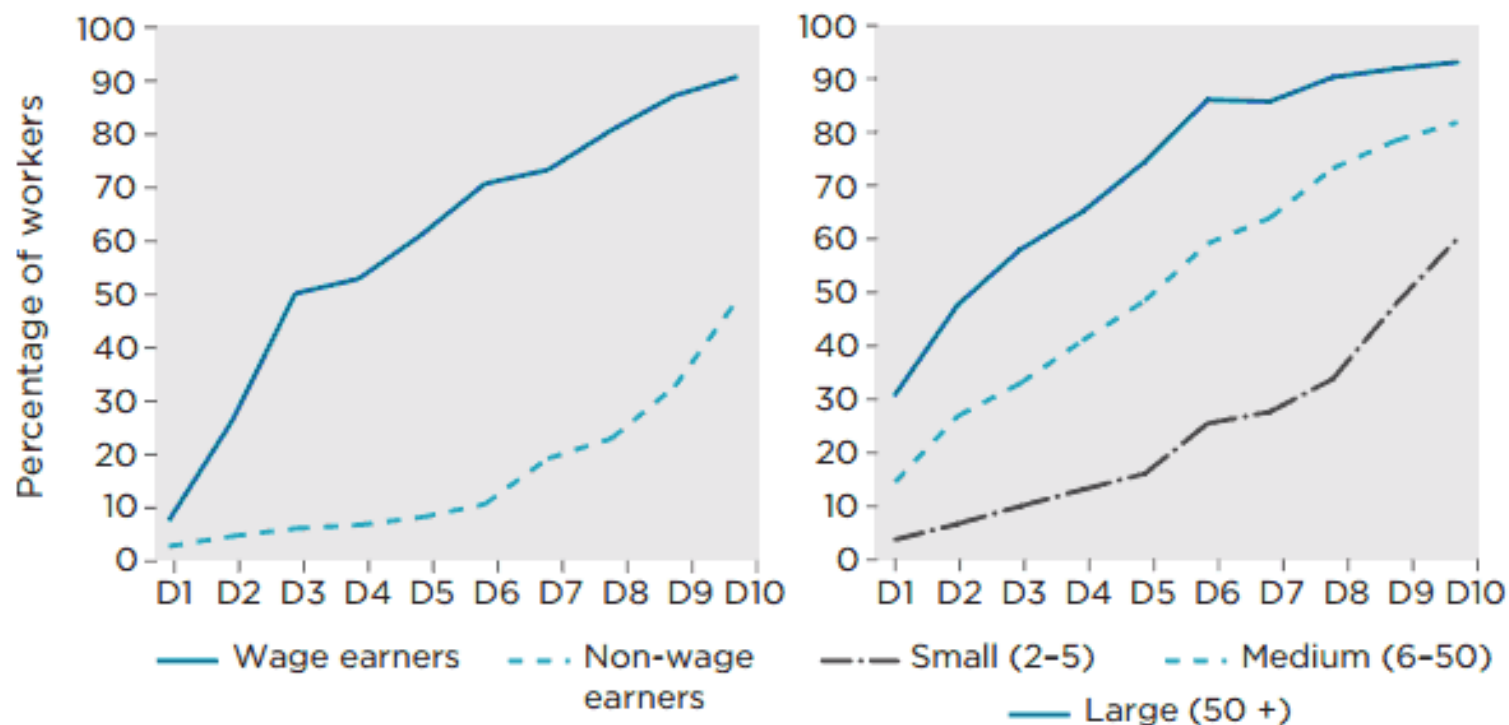
## Pension savings: Percentage of contributors over total employment in Latin America and the Caribbean, 2010



Source: Bosch, M., C. Pages and A. Melguizo (2013), Better Pensions, Better Jobs. IDB

... for non-wage earners, workers in small firms, or low-income workers ...

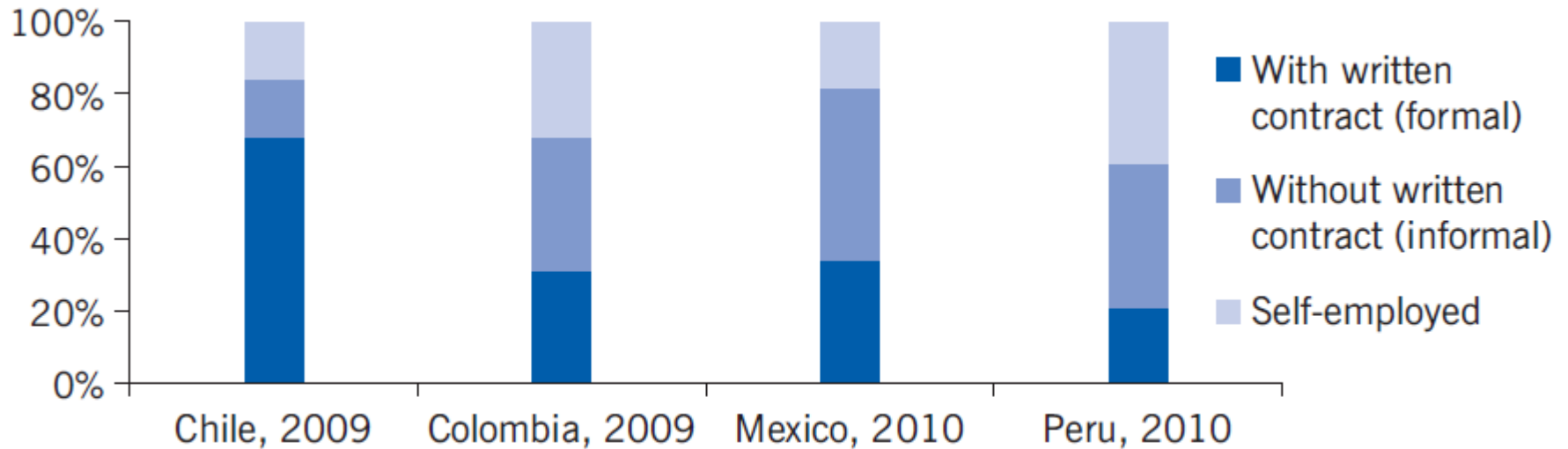
**Pension savings: Contributors to the pension system in Latin America and the Caribbean by income decile, occupation and firm size, 2010**



Source: Bosch, M., C. Pages and A. Melguizo (2013), Better Pensions, Better Jobs. IDB

## ... and the emerging middle class

Figure 2. Informality is high among middle-income workers



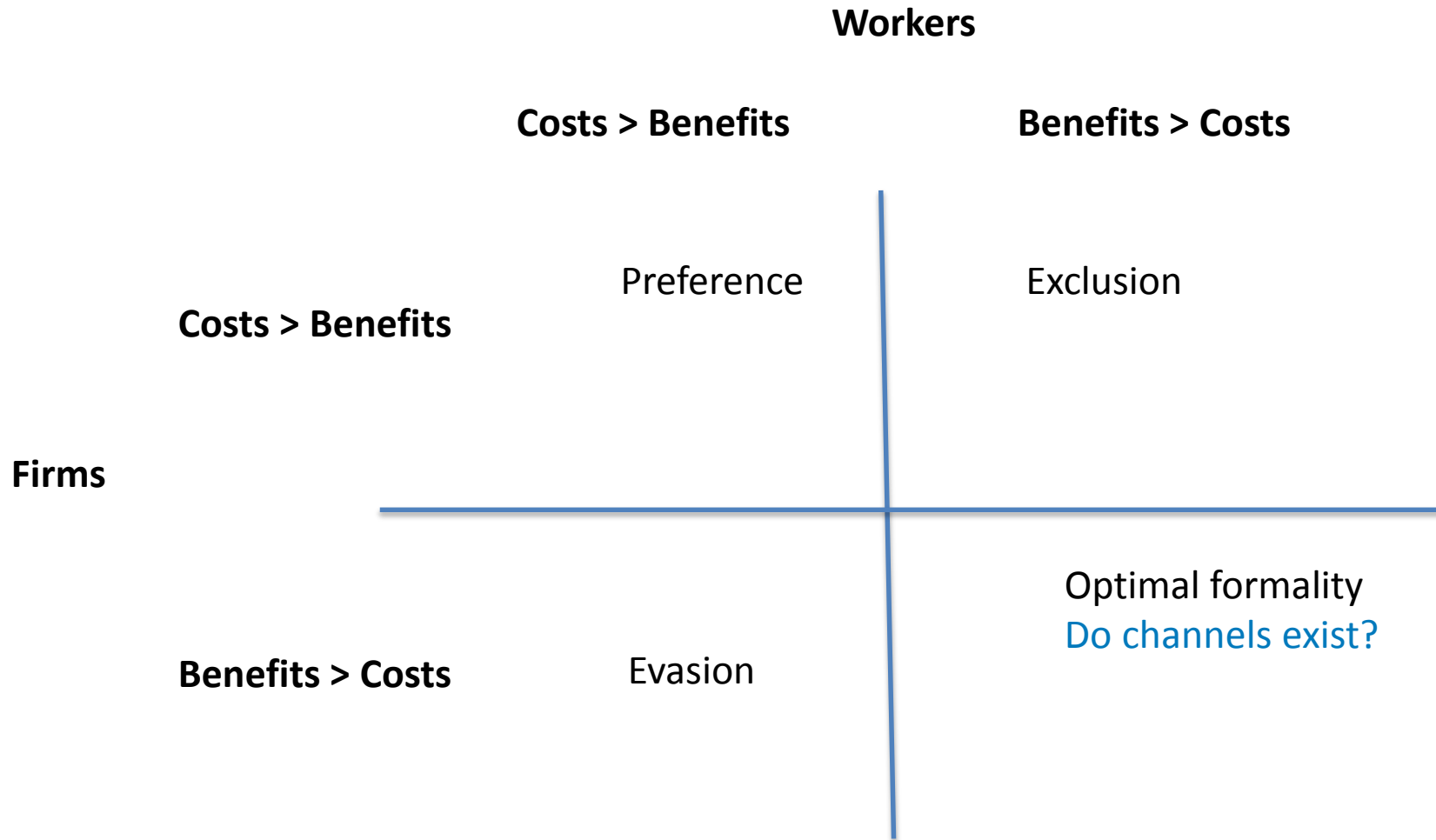
Note: Middle-income workers are defined as those earning 50–150% of median national income.



# Informality in Latin America: Taxes and beyond

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- **Taxes and informality: *in it together?***
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# Informalities

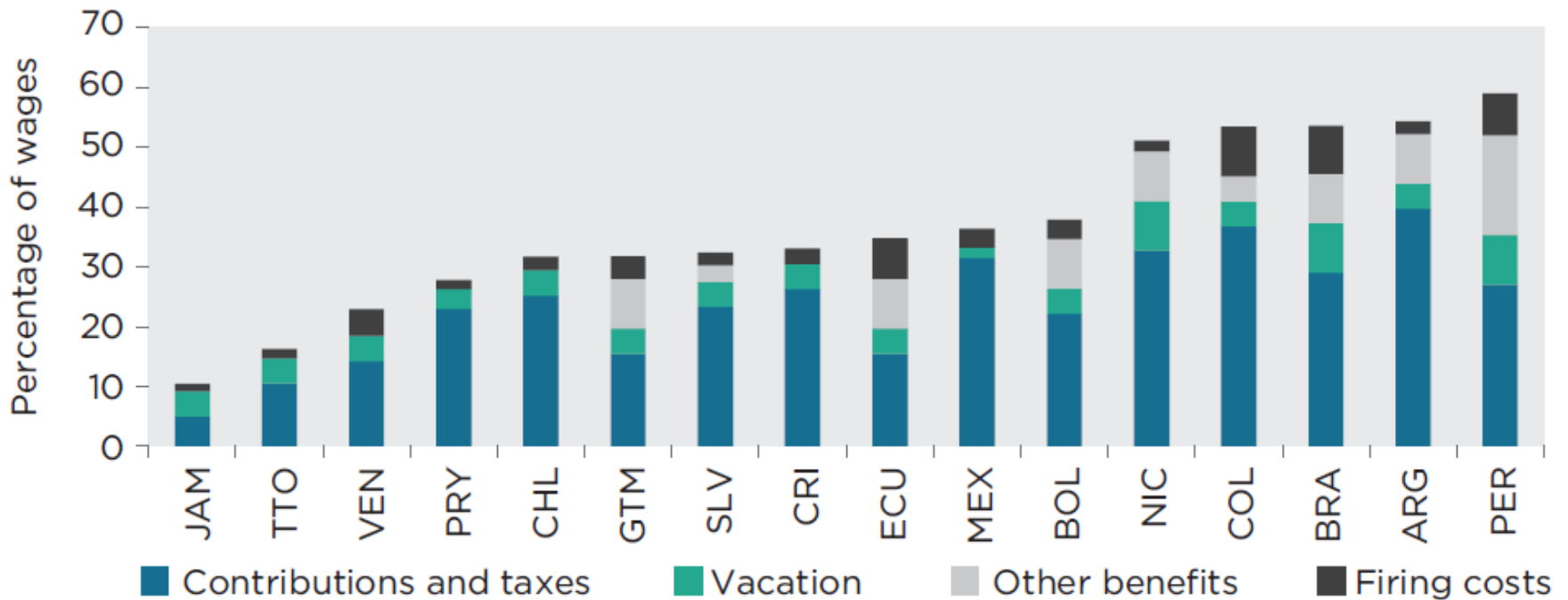


# Informality: usual (and less usual) suspects

- Difficulty for **long-term planning**
- **Imperfect design** of social insurance
  - Nor representative economic/labour model
  - Enforcement (e.g. channeled through the wage bill)
- **Disincentives to formality** for firms/workers
  - Non-wage labour costs and labour regulations (e.g. minwage)**
  - Non-contributory benefits
- **Low trust** in the State and/or financial sector
- **Low productivity**

# High costs of formality (taxes and labor regulation) could be playing a role...

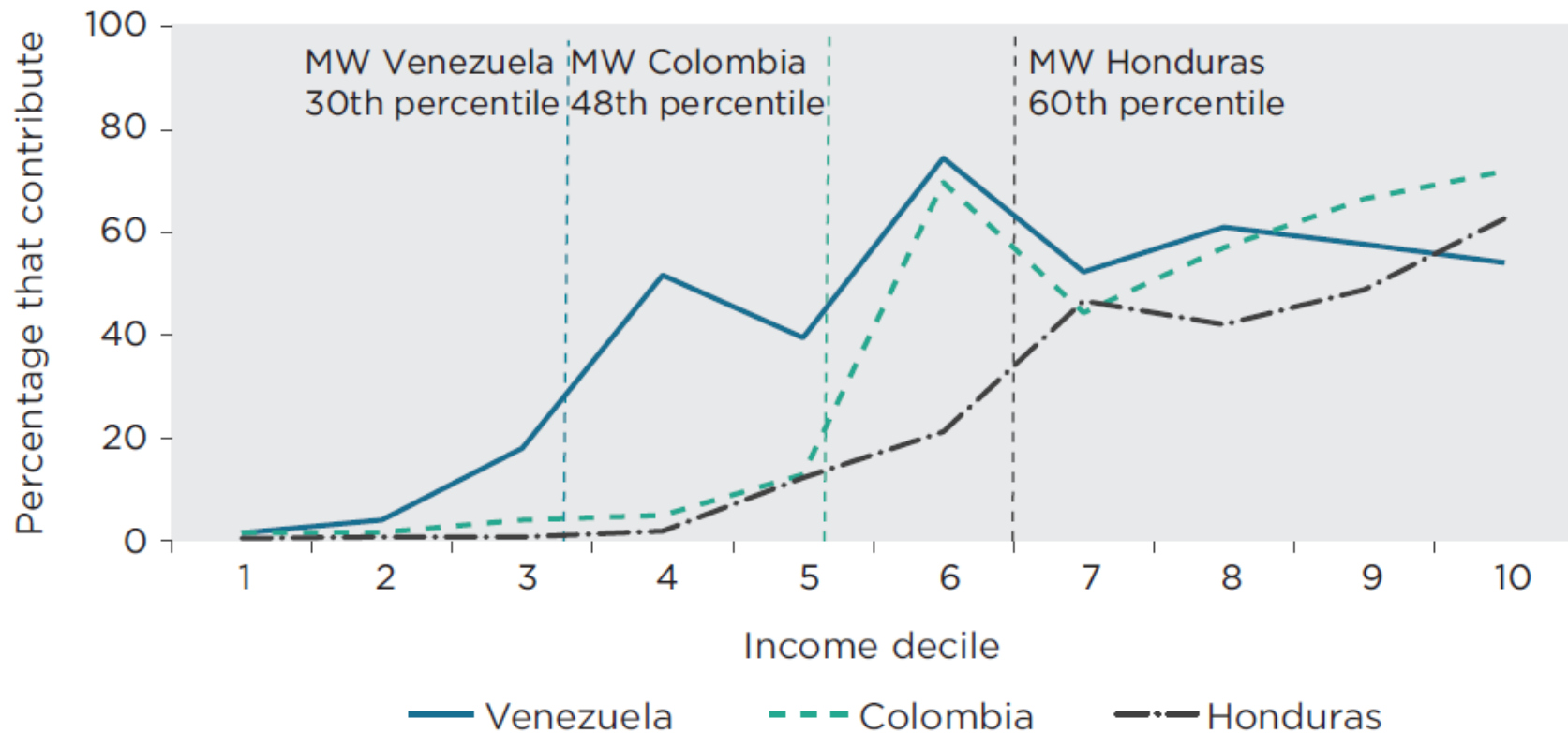
## The costs of formality in Latin America and the Caribbean, 2010



Source: Pages, C. (2010), The Age of Productivity. IDB

... especially when interacting with labor regulations

### Percentage of contributing workers, by income decile: Colombia, Honduras, and Venezuela



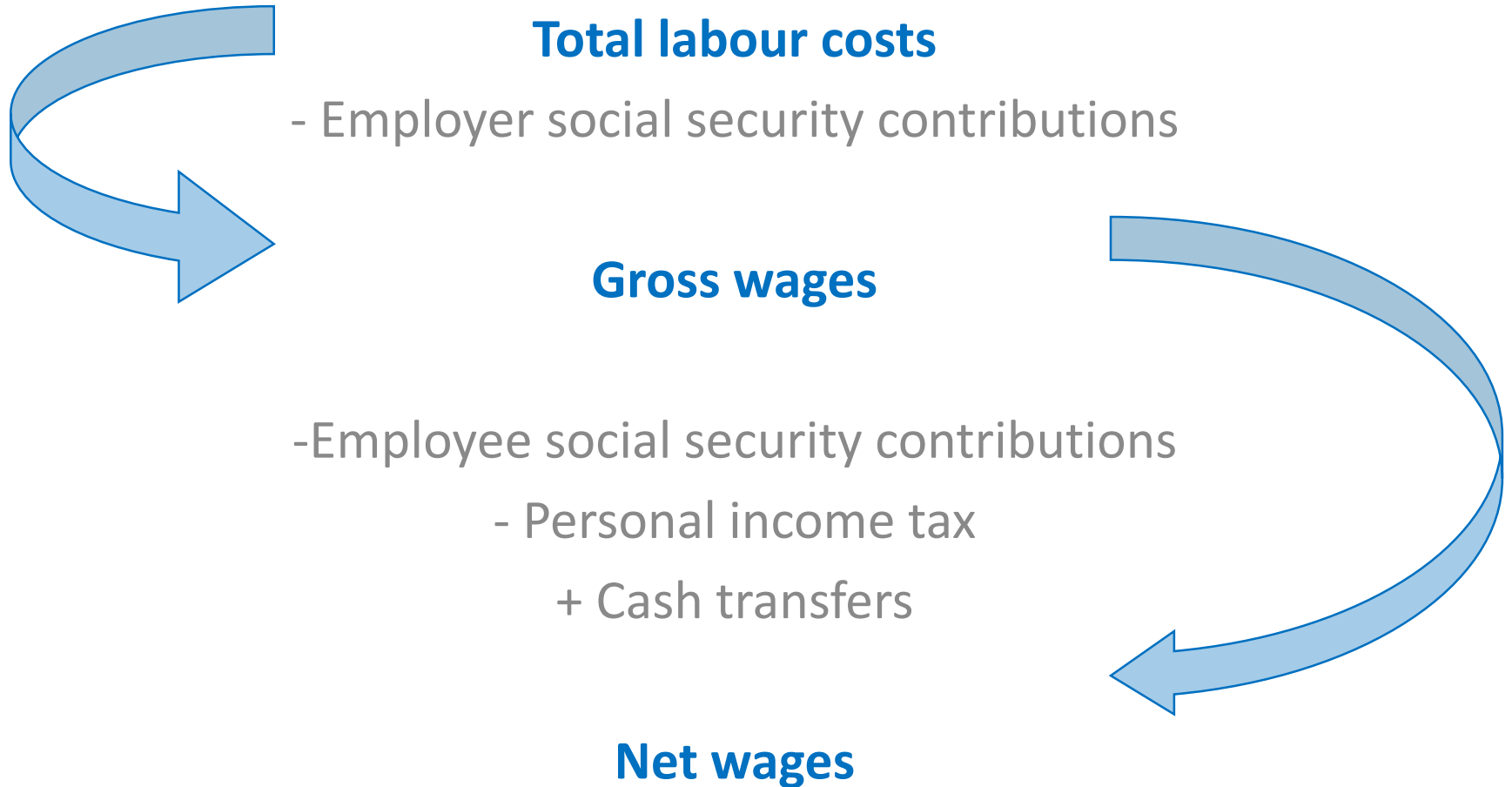
## *Taxing wages in Latin America: data first*

Comparable statistics for 20 LAC countries on **taxes on wages:**

- Social contributions (compulsory; private+public) and personal income tax
- Formal dependent worker
- By levels of income (deciles and USD)
- By family composition (single/couple; children)

*Special focus:* theoretical costs (taxes) to formalise

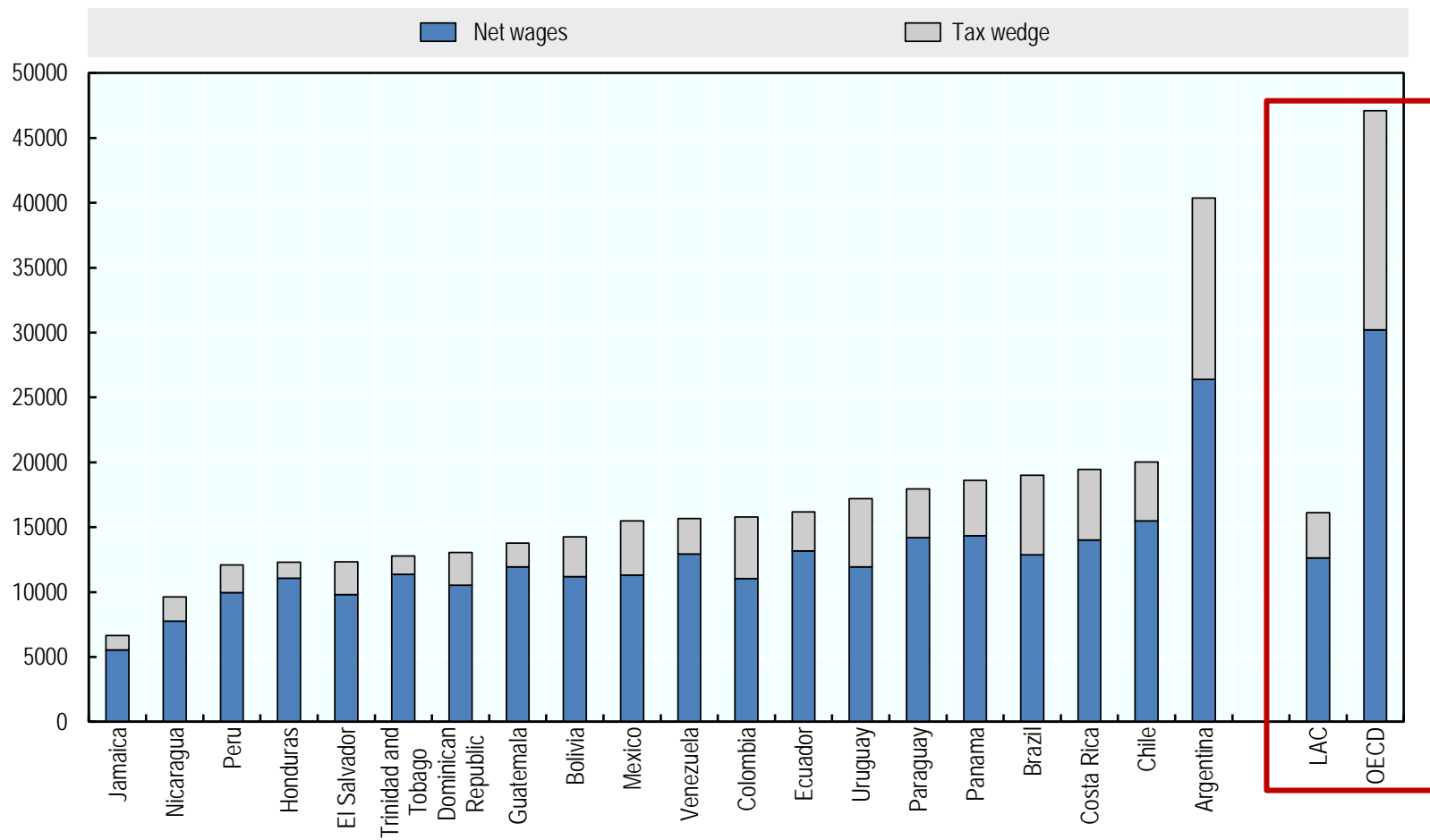
# *Taxing wages in Latin America: definitions*



# Labour costs in LAC are heterogeneous, and lower than in OECD (wages and taxes)

## Labour costs in Latin America and OECD

(Average wage earner; social contributions and personal income tax; 2013)

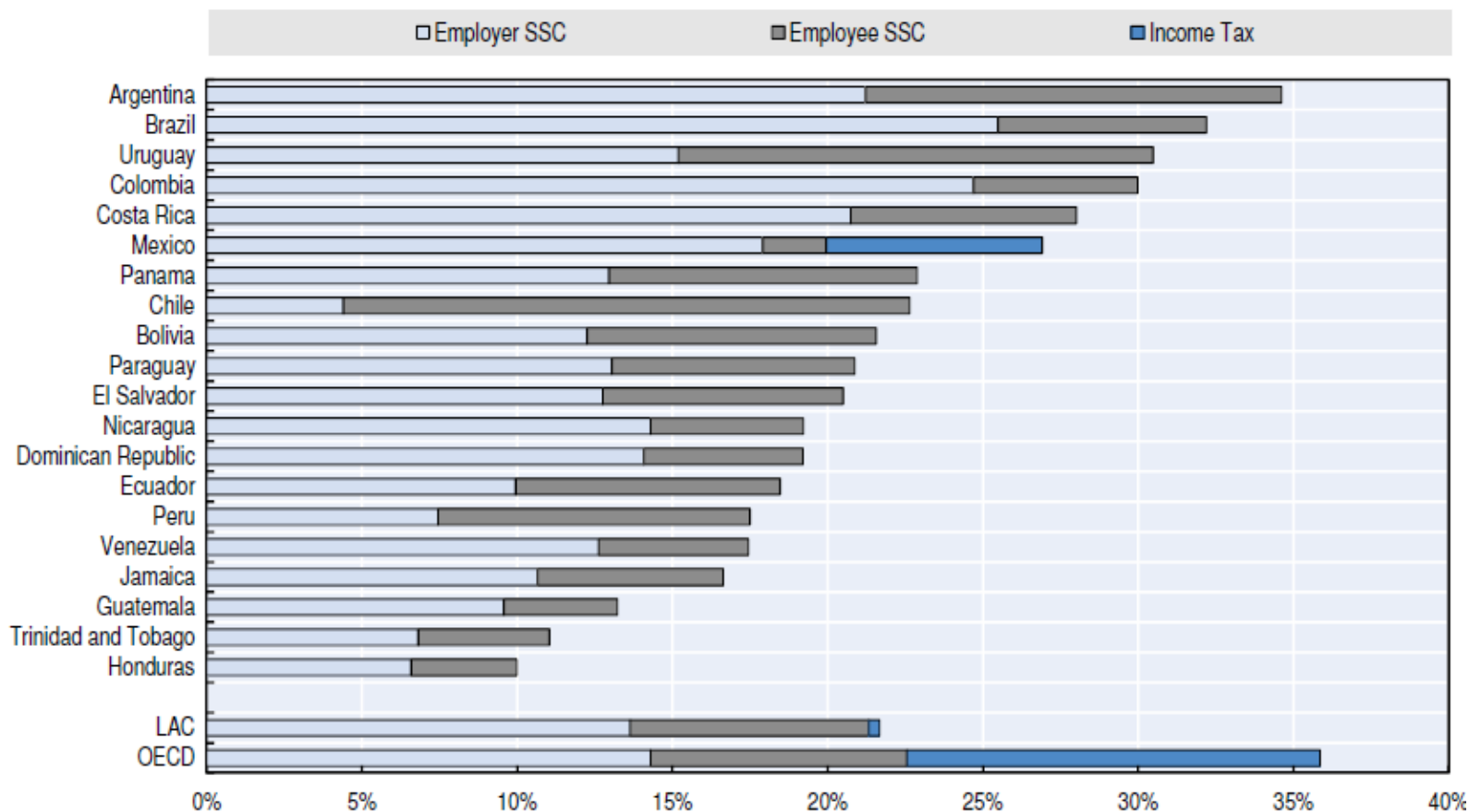


Source: OECD/CIAT/IDB (2016), *Taxing Wages in Latin America and the Caribbean*



# Lower labour costs are relatively low in LAC due to low taxes on wages (22% vs 36%)...

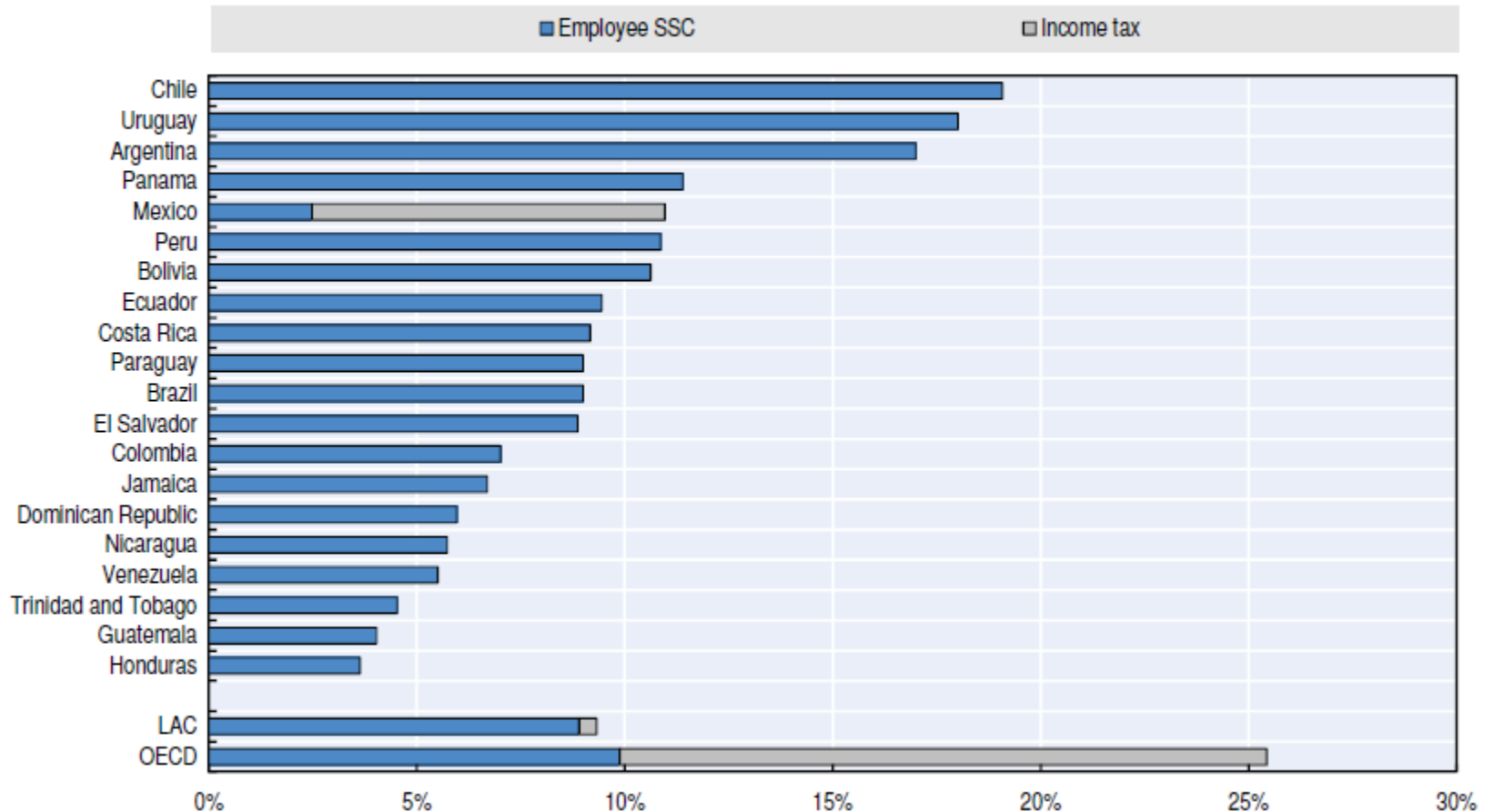
Figure 1.1. Income tax plus employee and employer social security contributions, 2013  
As % of labour costs



Notes: Single individual without children at the income level of the average worker.  
Payroll taxes are included with employer SSCs where applicable.

# ... explained by the personal income tax (average formal worker is exempted)

Figure 1.2. Percentage of gross wage earnings paid in income tax and employee social security contributions, 2013



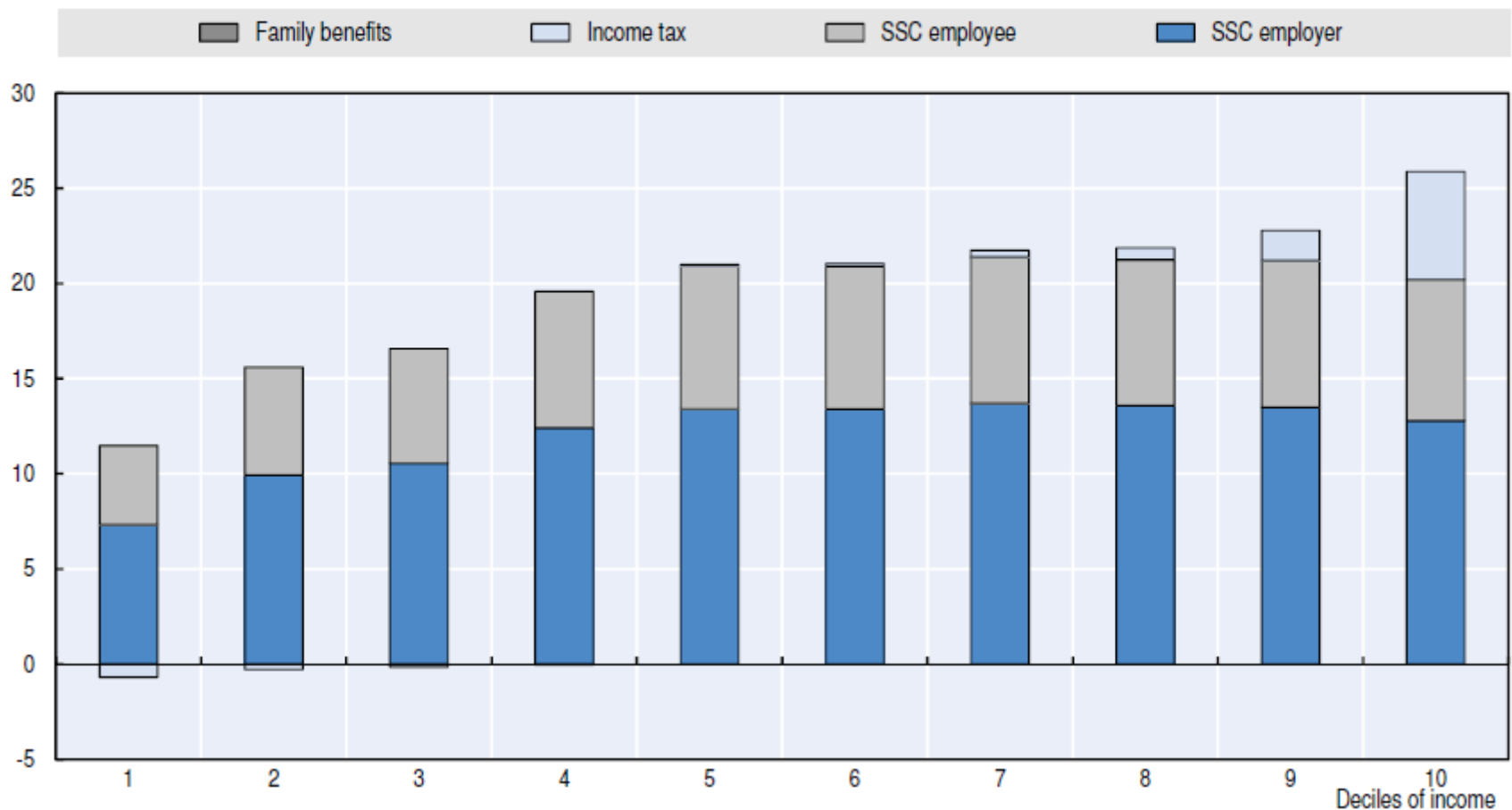
Notes: Countries ranked by decreasing tax burden.  
Single worker without children at income level of the average wage.

Source: OECD/CIAT/IDB (2016), *Taxing Wages in Latin America and the Caribbean*

# Personal income tax in LAC is borne fully by the two/three top deciles (low level though...)

Figure 1.4. Average LAC country wedge decomposition for a single earner with no children

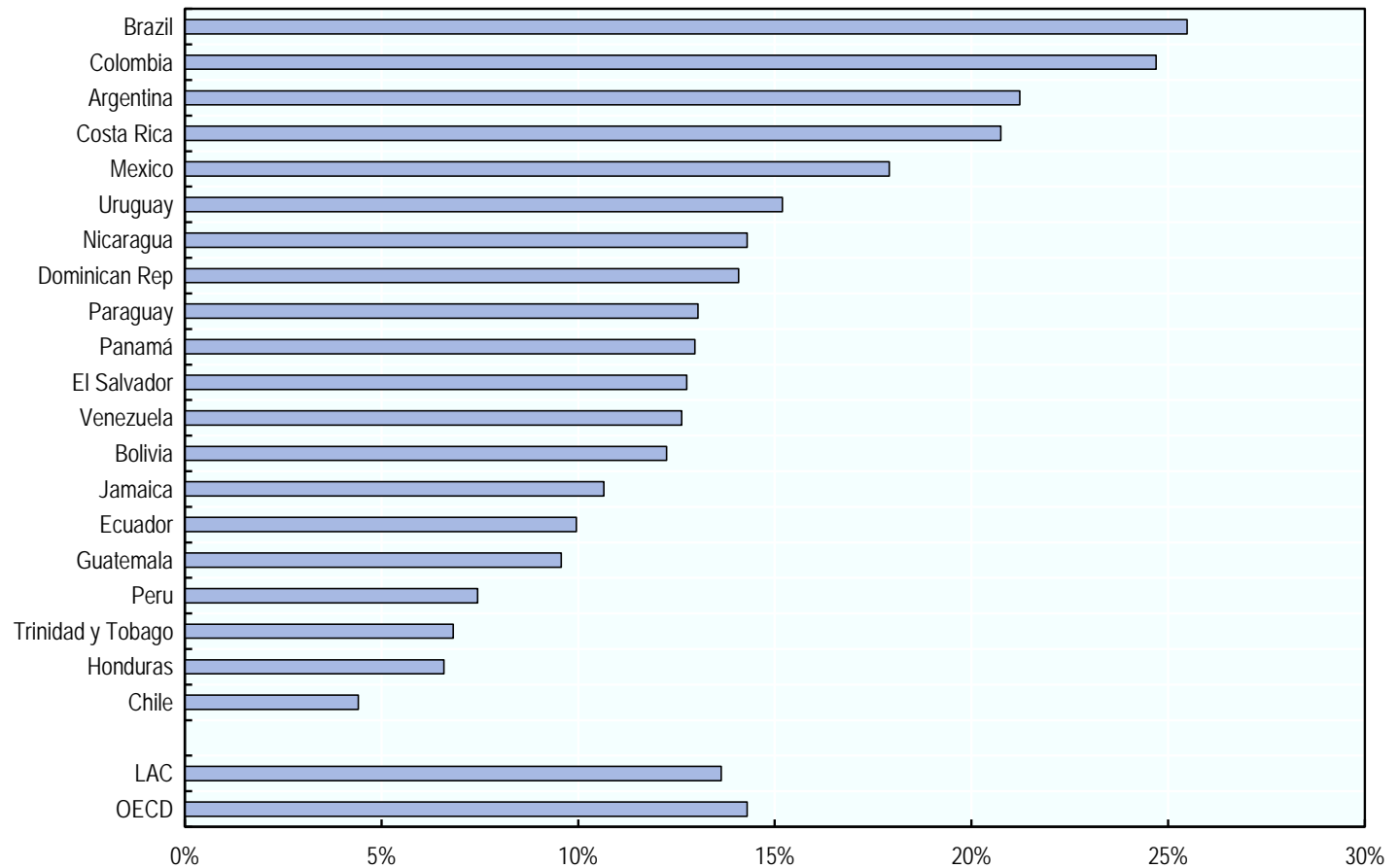
As a % of total labour costs



# Employer contributions are alike in LAC and OECD

## Employer social contributions in Latin America and OECD

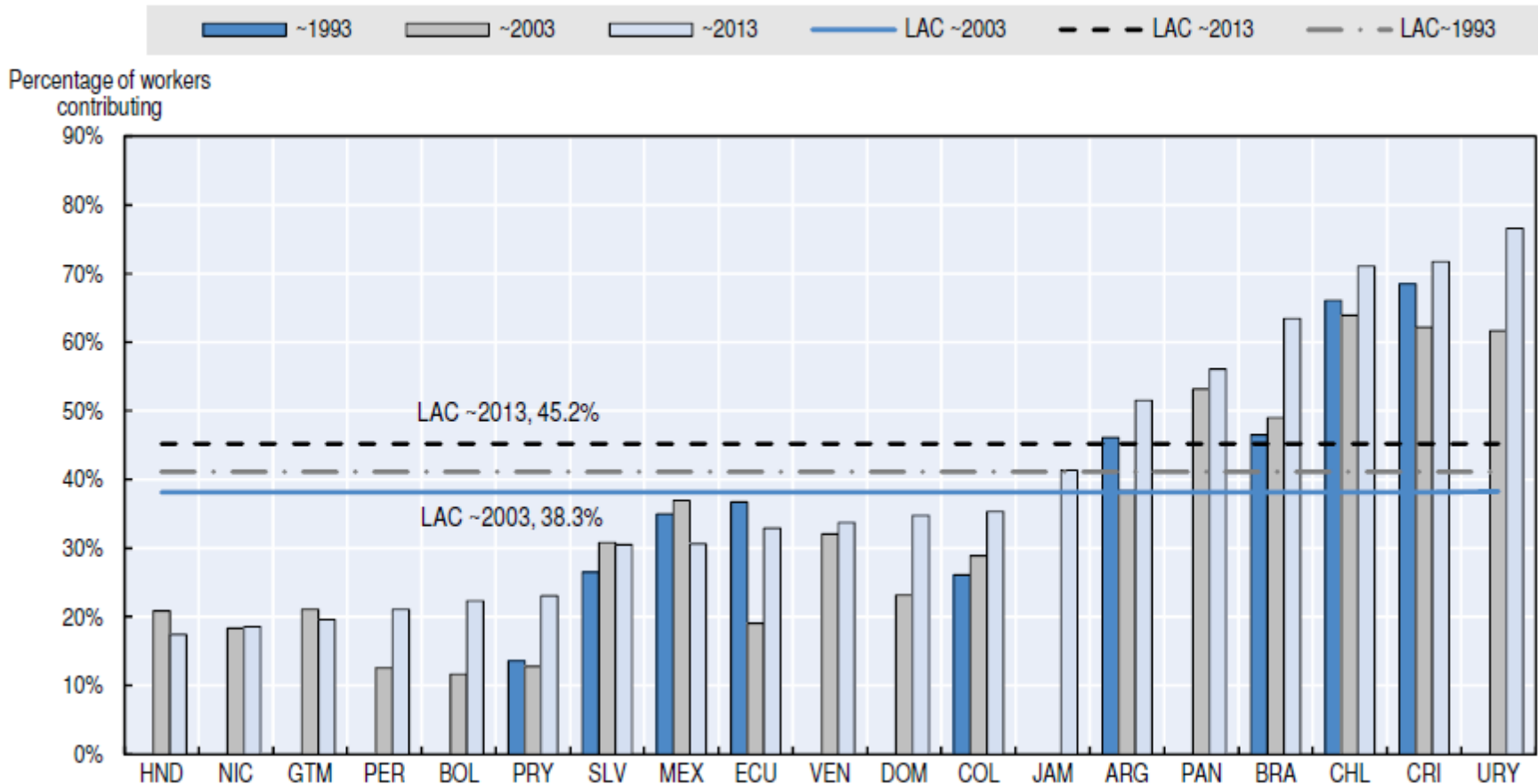
*(Average wage earner; % labour costs; 2013)*



Source: OECD/CIAT/IDB (2016), *Taxing Wages in Latin America and the Caribbean*

# What about those (55% workers) who are informal?

Figure 2.3. **Formality rate in Latin American and Caribbean countries**  
(Percentage of workers contributing to social security- aged 15-64 years)



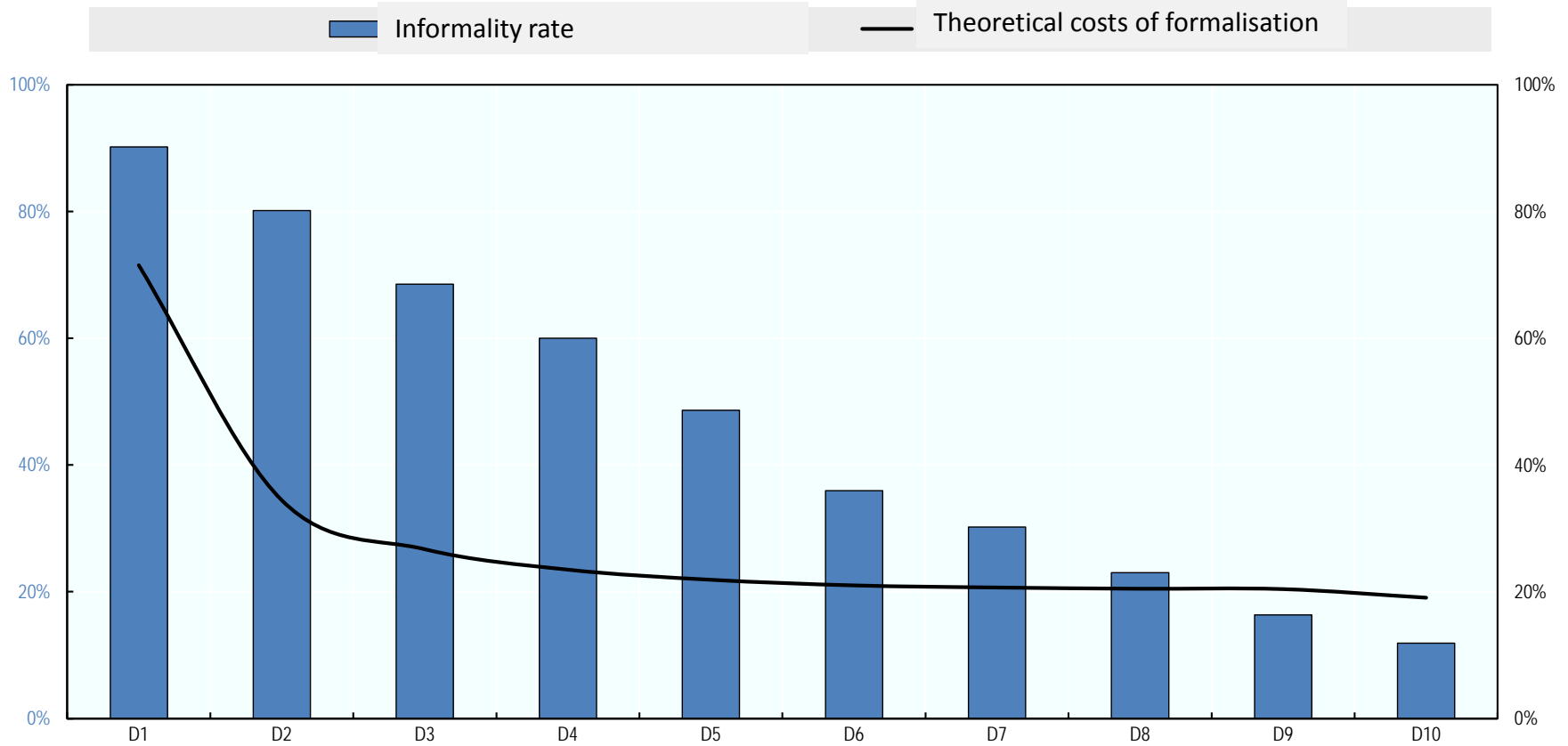
Note: The formality rate is computed for all employed workers (not only salaried workers) aged 15-64 years.

Source: IDB (2015). Sistema de Indicadores de Mercado Laboral y Seguridad Social (SIMS).

# Calculating the (tax) costs of formalisation..

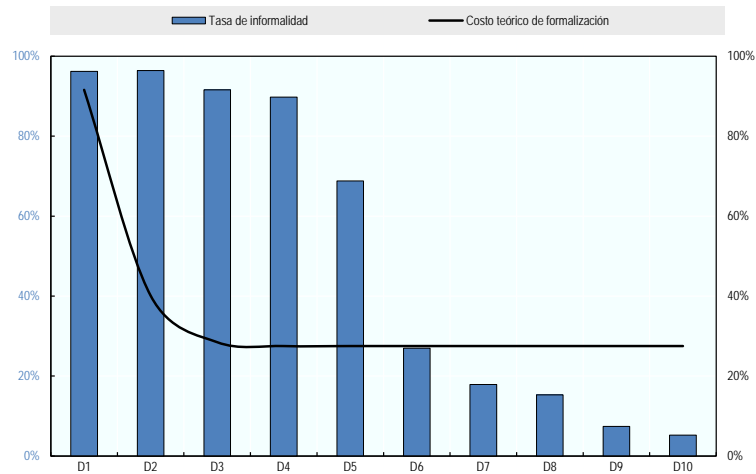
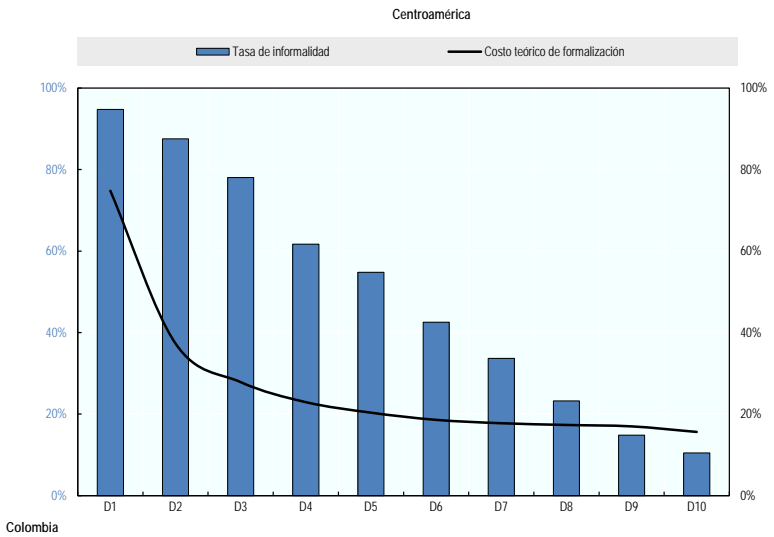
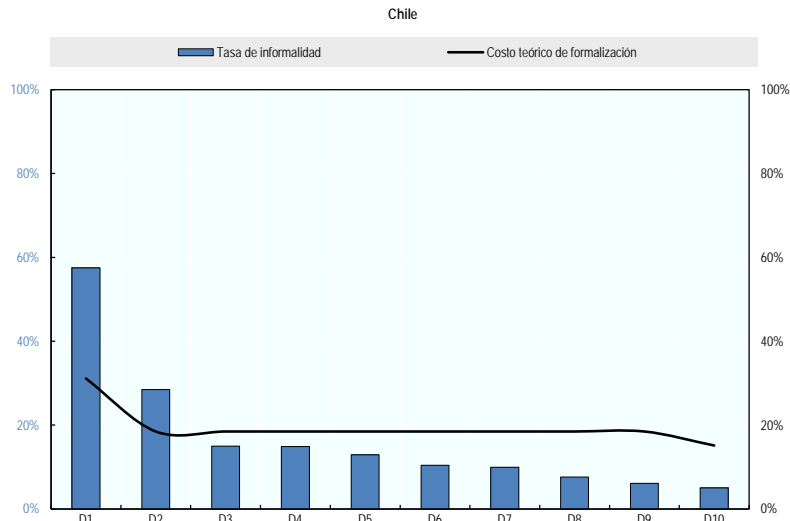
## Informality and theoretical tax costs of formalisation in Latin America

(Average LAC wage earner by income decile; % wages; 2013)



Source: OECD/CIAT/IDB (2016), *Taxing Wages in Latin America and the Caribbean*

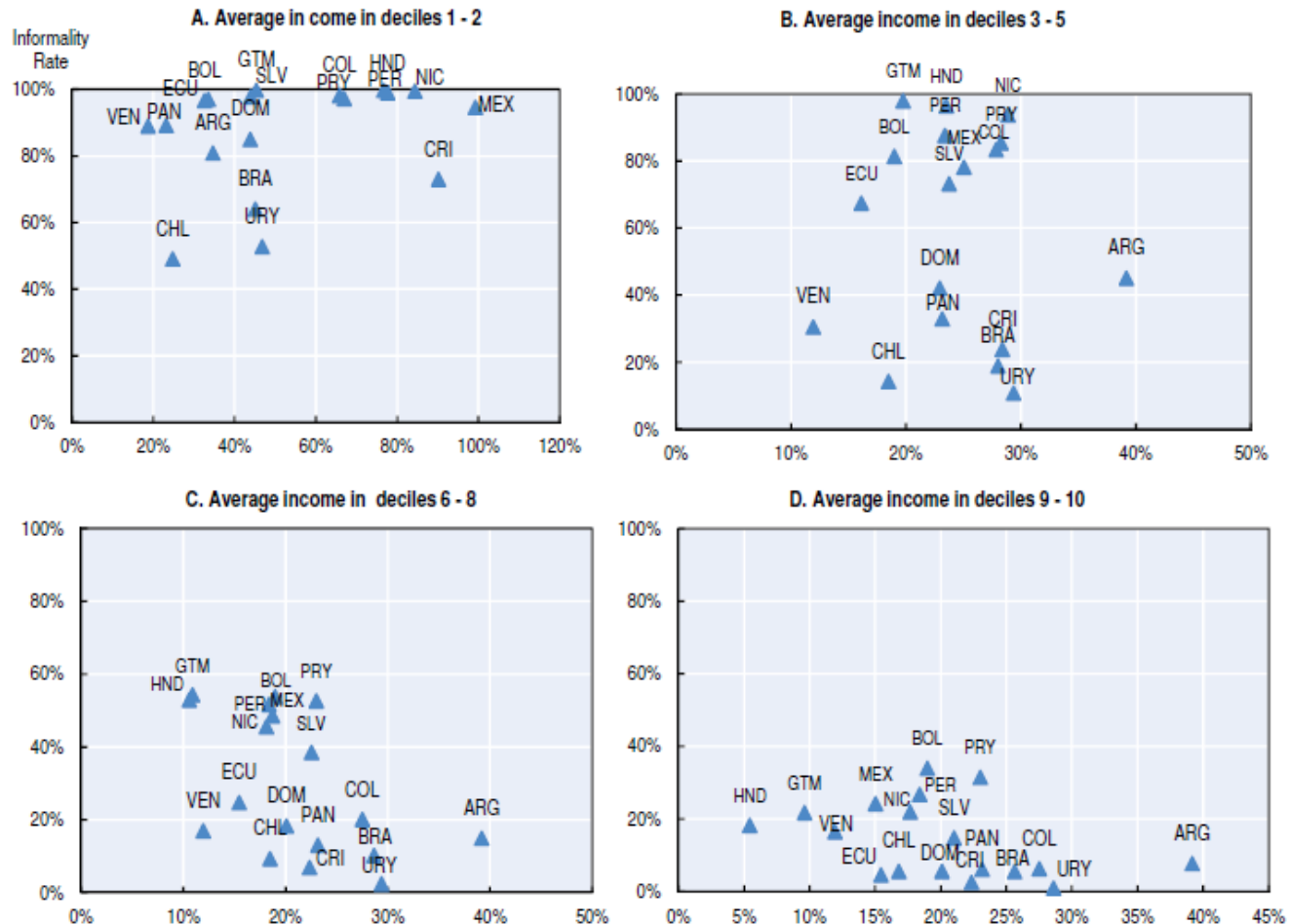
# Americas Latinas



Source: OECD/CIAT/IDB (2016), *Taxing Wages in Latin America and the Caribbean*

# Taxes and informality are correlated for low and middle-income workers (*vulnerable middle class*)

Figure 2.8. The relationship between formalisation costs and informality  
A cross country approach by income decile



Source: OECD/CIAT/IDB (2016), *Taxing Wages in Latin America and the Caribbean*



# Taxes and informality: *in it together?*

Theoretical indetermination and not conclusive empirics

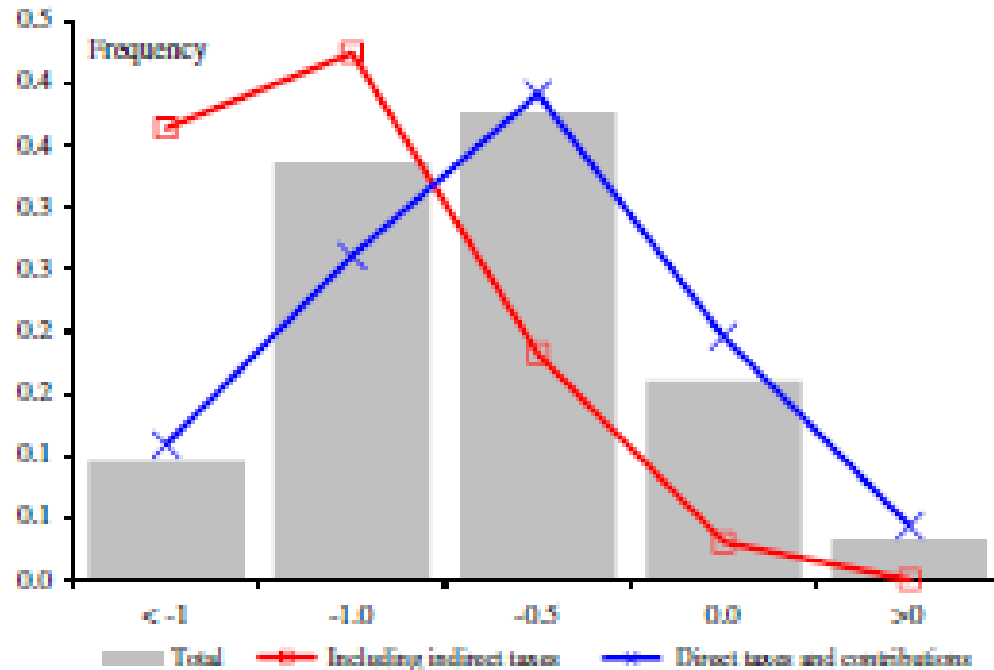


Fig. 4 Distribution of wage elasticity to taxes (tax wedge composition)

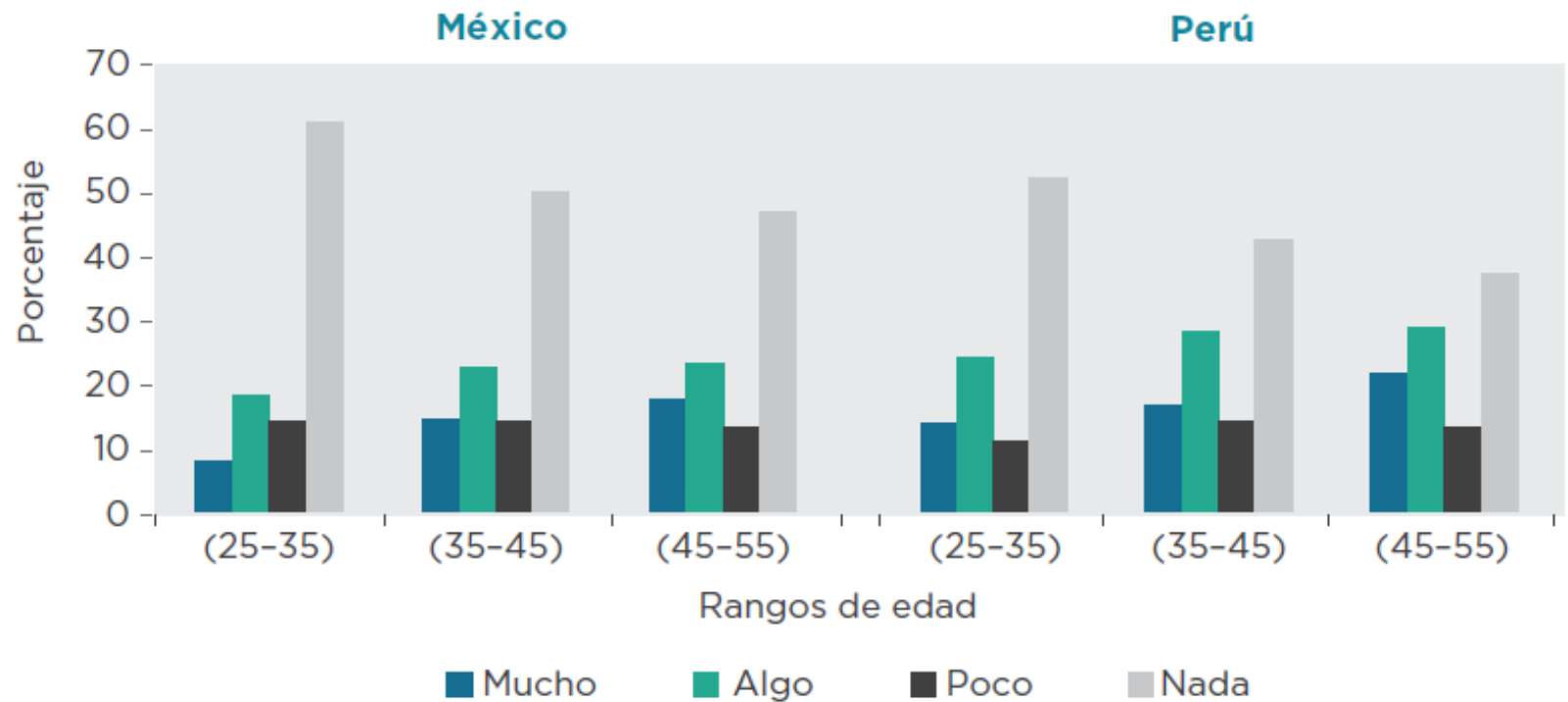
Source: Gonzalez-Paramo, J.M. and A. Melguizo. (2013), Who pays labour taxes and social contributions? A meta-analysis approach. SERIES, 4, 247-71

# Informality in Latin America: Taxes and beyond

- *Informal is normal* in Latin America
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- **Beyond taxes: *a way forward***

# Procrastination and overconfidence traps

Have you thought about financing your retirement?



Source: Bosch, M., C. Pages and A. Melguizo (2013), Better Pensions, Better Jobs. IDB

## Usual suspects *beyond taxes*

- Difficulty for **long-term planning**
- **Imperfect design** of social insurance
  - Nor representative economic/labour model
  - Enforcement (e.g. channeled through the wage bill)
- **Disincentives to formality** for firms/workers
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# Principles of a pro-formality agenda

- **Global:** interactions between social protection (pensions, health) and taxes
  - + **Coordination** among institutions (regulation, supervision, administration)
- **Efficiency:** incentives to formal labour participation
- **Innovation:** supervision and compliance mechanisms
- **Transparency:** simple goals; public debate and political agreements

# Policy goals and levers

**Incentives** for formal jobs (including tax cuts)

**Enforce/re-design** (especially for self-employed)

Increase **information** and financial education

Open databases

Impact evaluation

## **Innovate**

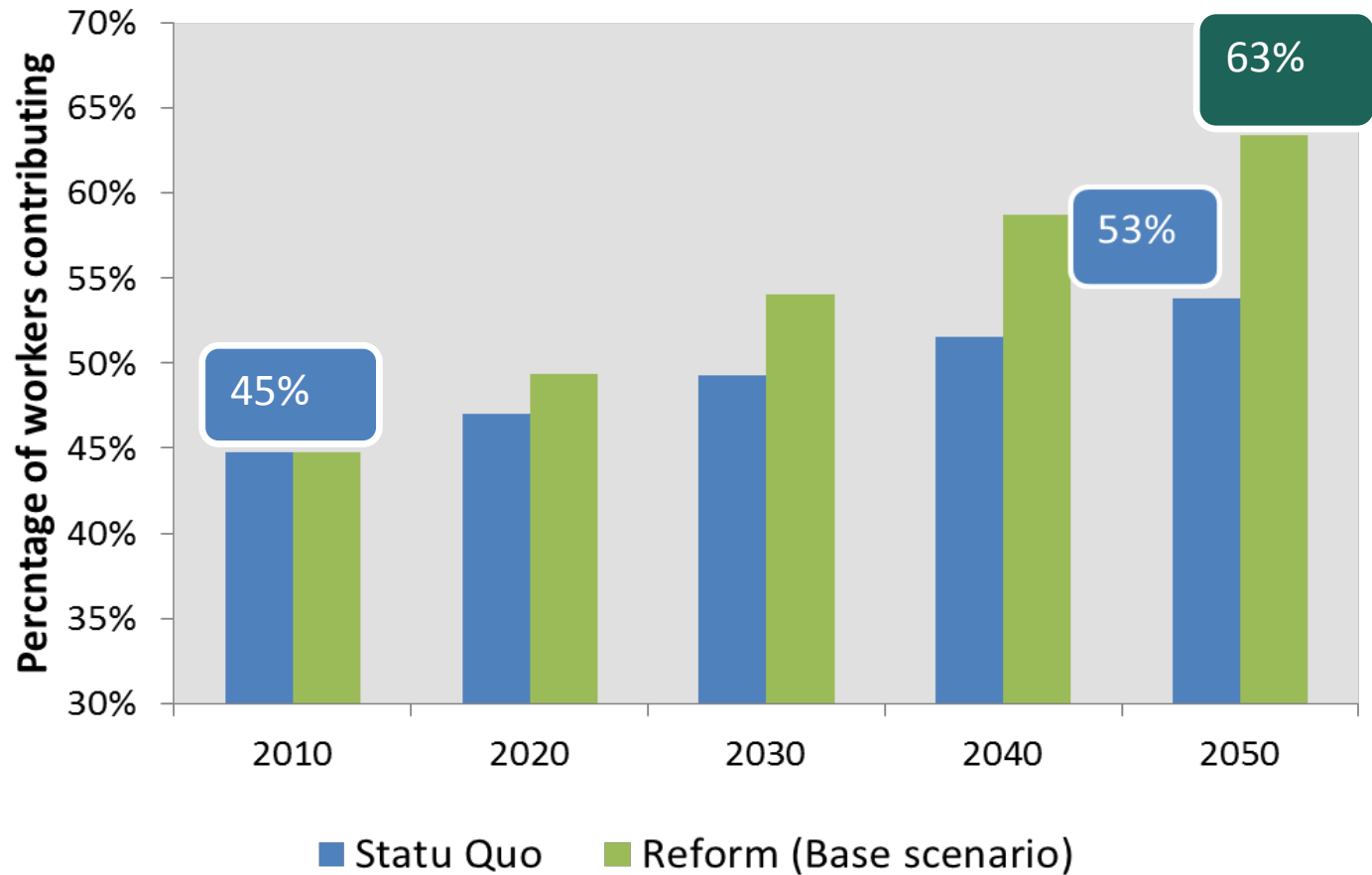
Comunication

Channels

Default options

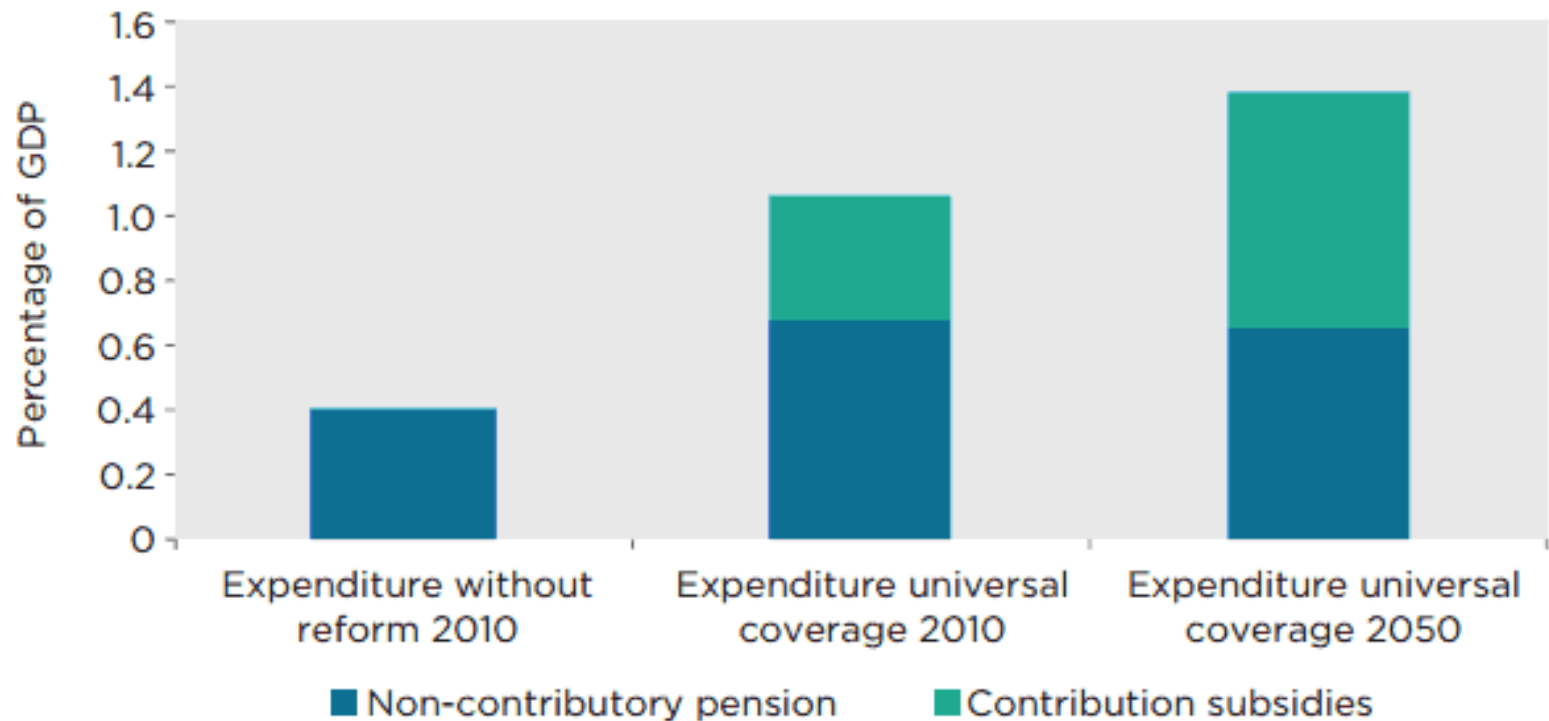
# Better jobs: Subsidizing formal employment...

## Projections of formality in Latin America



# *Better jobs: ... at reasonable fiscal costs*

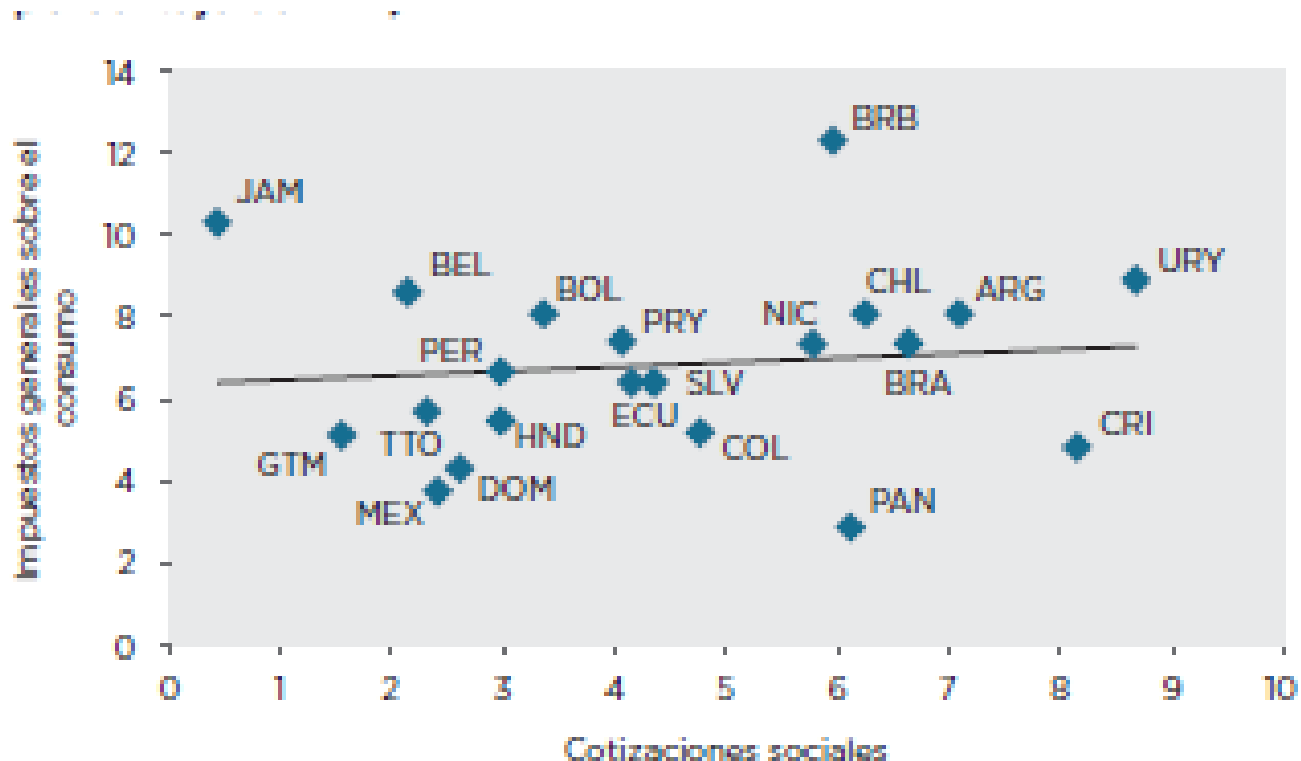
## Cost of pension reform, compared with current spending on non-contributory pensions





# Better jobs: Financing choice would depend on current and future tax revenues

## Consumption taxes and pension and health contributions in Latin America and the Caribbean, 2012 (Percentage of GDP)

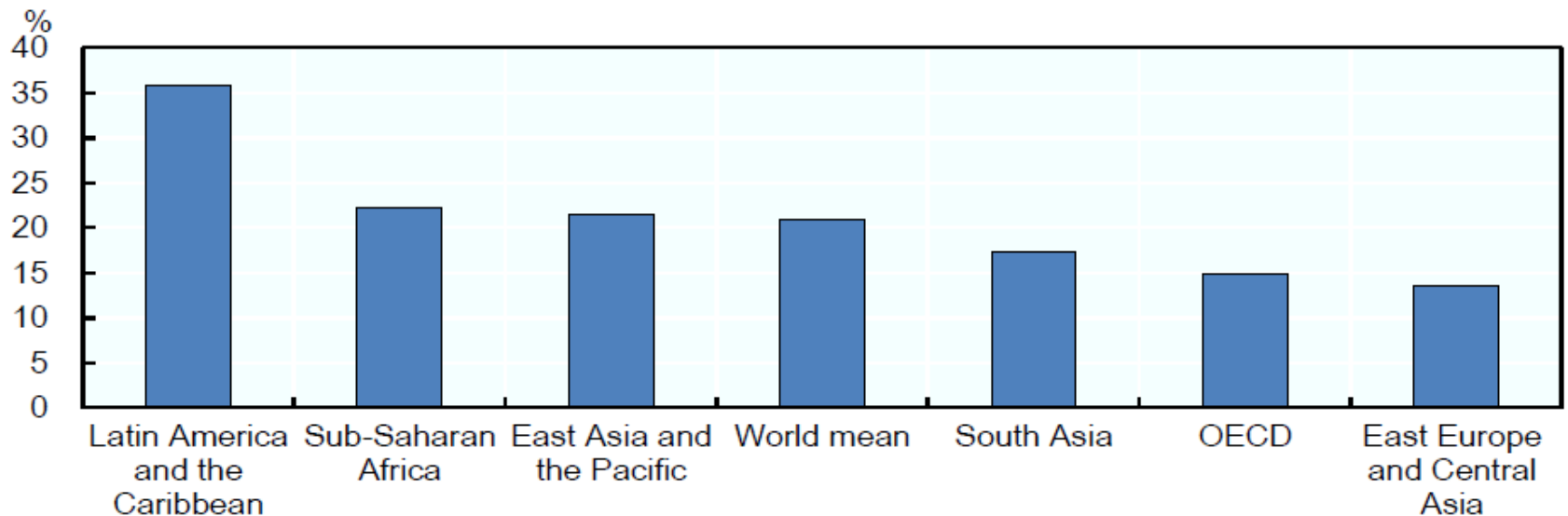


Fuente: BID y CIAT (2012).

Nota: El dato de cotizaciones sociales incluye todos los aportes a pensiones y salud públicas y privadas de contribución obligatoria.

# Better jobs: Pro-formality policies and productive development policies - Skills...

Figure 2. Firms finding major or very severe performance obstacles derived from skills by region (% of surveyed firms, circa 2010)



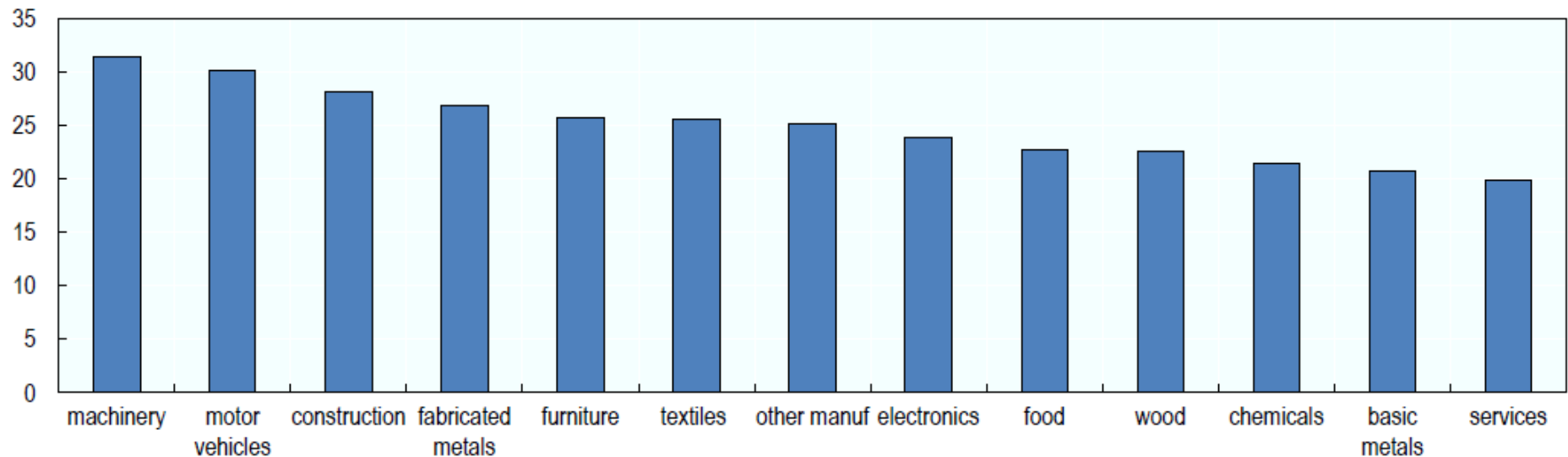
Source: World Bank (2015a), *Enterprise Surveys Database*.

Source: OECD/ECLAC/CAF (2014), *Latin American Economic Outlook 2015*.

# *Better jobs: ... the new XXI century currency*

**Empresas en Colombia que consideran como una barrera importante la falta de una fuerza laboral adecuadamente formada (% empresas formales, circa 2010)**

**Figure 3. Firms finding major or very severe performance obstacles derived from skills by sector (% of surveyed firms, circa 2010)**



Source: World Bank (2015a), *Enterprise Surveys Database*.

# Informality in Latin America: Summing up

- ***Informal is normal*** in Latin America  
(and we do not like it too much)
  - 55% workers
  - Also a middle-class challenge
- Taxes and informality: ***in it together?***
  - Yes: taxes on wages can be burdensome, especially for the transition informality-formality
- Beyond taxes: ***a way forward***
  - Comprehensive pro-formality package: incentives (monetary & nudged) and productive development policies

# Main references

- Better Pensions, Better Jobs

<https://publications.iadb.org/handle/11319/462?locale-attribute=es>

- Pensions at a Glance in LAC

<http://www.oecd.org/publications/oecd-pensions-at-a-glance-pension-glance-2014-en.htm>

- Taxing Wages in LAC

<http://www.oecd.org/development/taxing-wages-in-latin-america-and-the-caribbean-2016-9789264262607-en.htm>

**Thanks!**

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**ELLA Summit on Informality and Inclusive Growth**  
Johannesburg, October 4-5 2016

## Taxing wages in Colombia and South Africa

*(Social contributions and personal income tax; 2013)*

