Policy Brief

Socio-Economic Outlooks
November 2017

Social security and labor market informality in Latin America

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Summary

This document answers how the development of social security systems in Latin America is compromised by the high levels of labor informality in the region. We analyze the fiscal expenditure scheme in the region as a whole, thereby showing that high levels of informality in Latin America's labor markets closely relate to how it is impossible for governments to increase revenues by broadening the taxable base. This challenges the government's ability to cope with the soaring social demands, as it severely limits is fiscal consolidation.

Policy Considerations

In economic policy, Latin American governments need to develop policies that effectively approach informality both as a structural component of their economies and as an urgent socio-economic concern to be solved.

Policies intended to combat informality should operate on a parallel, two-layered timeframe: i) in the *short-run*, policies should be introduced to streamline regulations and strengthen monitoring and enforcing actions; ii) in the *long-run* policies should be introduced to target economic structural limitations, for instance, providing and improving public infrastructure, services and institutions, and supporting human capital formation.

Concerning social policy, the State must recover and reinforce its role as the social services and goods provider. A comprehensive reform of social institutions must be undertook in order to substitute the public financing of multiple social security systems for a less intricate and more efficient scheme of universal coverage that guarantees effective access to social security to its entire population.

1. Introduction

Latin American recently experienced an the first important transformation of its social security regimes since their creation during the post WW-II era. The transformation of the role of the State in regard to the provision of social services to its population has been framed by the economic developments of the region. This is especially true regarding the adoption of the Washington Consensus agenda in the 90's and its implications for the evolution of social security institutions and the performance labor markets.

This document explores the relation between social security systems in Latin America and the informality in the region's labor markets. Our objective is to answer the question: 'H**ow is the development of social security systems in Latin America compromised by the high levels of labor informality in the region**?' To demonstrate this, we provide evidence showing the financial limitations of Latin American social security systems and their relation to the persistent high levels of informality in labor markets. We argue that any public policy intended to overcome these issues must approach such dynamics by giving a central weight to the structural nature of informality while addressing its short run implications for Latin American societies.

This document is organized as follows: the first part discusses the institutional evolution and financial structure of social security systems in Latin America, including an assessment of its funding limitations and its link with informality. The second section advances a conceptual discussion of labor informality and how it affects the fiscal capacities of the government, proceeding to explore its evolution and structure in Latin America. Finally, in conclusion, we present some remarks and policy implications regarding the two features of the Latin American economies previously analyzed

2.1. Development of social security systems in Latin America

Social security systems are the public policies, public or private institutions, and the legal framework of a country intended to provide relief and support to households and persons during circumstances affecting their well-being throughout their life cycles (Centrágolo, 2009:13).

In Latin America, the construction of social security systems is closely linked to the evolution of the region's economic structure. Although there are clear differences in the particular structures of national social security systems, we can broadly identify a similar regional pattern of development. The first attempts to build national social security networks by the Latin American countries took place around the 1950s. Under the import-substitution economic paradigm, governments began to deploy a centrally-managed social policy based on the formal employment of urban workers. The underlying assumption was that the region was going through a structural transformation of its economic systems whereby an increasingly large proportion of the population would join the formal economy, eventually enabling near-universal social coverage of the population.

After the Latin American debt crisis of the early 80s and the progressive transition of the world economy from a domestically-based industrialized capitalism to a globally-based financial capitalism, the social security model in Latin America proved limited in its reach. The region started implementing the structural adjustment programs of the Washington Consensus, which argued in favor of open economies, macroeconomic equilibrium, market liberalization and, regarding social policy, a change in the role of the state from a "social services and goods" provider to that of a "regulator and market's subsidiary".

Departing from the idea of economic efficiency, this new model also supported the deregulation of labor markets, arguing in favor of the flexibility of contractual relations and the reduction of wage costs. An unintended outcome of the implementation of this set of policies was high unemployment rates with an increase in self-employment, informality and job instability (Filgueira, 2014:27-28).

Since the mid-90s a complementary set of social policies started to be implemented in some Latin American countries after popular demands for mitigating the effects of a drastic liberalization of their economies. Focalized programs and conditional cash transfers for poverty alleviation, and for coping with any extraordinary or unexpected expenditure which could jeopardize present and future wellbeing of households and individuals; in other words, a complementary institutional and policy network for the provision of social security. However, these new social security frameworks and programs did not modify the underlying logic and institutional arrangements of the welfare systems recommended by the liberalizing agenda, which considered markets as the preeminent mechanism for the allocation and provision of social services.

After the 2000s, this new approach to social policies further evolved to recover some of the structural characteristics of the post-war social security systems in Latin America. This includes the principle of universal access to social and economic rights, as well as the conception of the State as a key agent in guaranteeing such access for the population.

In retrospect, Latin American countries significantly improved their social security systems since the mid 20th Century, with the most important components being set up in the last 25 years (ECLAC, 2016:158). Nowadays, the social security landscape in Latin America can be described as a diversified one, with significant differences regarding its coverage, institutional organization and means of financing. The majority of these differences arise from the combination (in some cases even overlap) and extent to which each country relies on market-based or State-managed mechanisms for the provision of social services.

2.2. Financial dimension of social security in Latin America

This diversity of social security schemes in Latin America poses several challenges for their expansion and improvement. One of the most crucial questions refers to the financial dimension of social security systems and involves two fronts: (i) government social spending and (ii) the funding of public social expenditures.

Government social spending

From 1990 to 2013 Latin America observed a real and sustained increase in public expenditures on social services. This rise can be observed using two indicators (i) public social spending as share of GDP, and (ii) social public expenditure as a percentage of total public expenditure.

Figure 1 shows not only this upward trend but, more importantly, it allows us to see the previously mentioned streamlining of social security systems in Latin America: while during the tequila crisis (1994-95) public social spending remained practically unchanged, during the global financial crisis (2008-09) this ratio registered the most important increase of the whole period, even when the regional economy contracted by 1.6% (ECLAC, 2016:15). This is explained by a general shift in the behavior of public social spending after 2005 towards one that incorporated countercyclical policies, was more resilient to the economic cycle and increasingly resistant to external shocks (ECLAC, 2016:62). We must note that this new approach to social expenditures included important public employment programs and enhanced non-contributory social protection (ECLAC, 2016:63).

In contrast, despite the rise of public social spending as a share of GDP in the past 25 years in Latin America, there is a systematic gap between the regional average and the OECD average (**Figure 2**). These relatively low levels of public expenditure on social services pose important constraints to the enlargement and consolidation of social security systems.

In order to better understand such weak fiscal expenditure in the region, two aspects must be assessed: (i) the allocation of current budgets and (ii) the limitations for increasing tax revenues. We shall focus on the latter, as it relates to the regressive fiscal structures and high labor informality of Latin American countries.

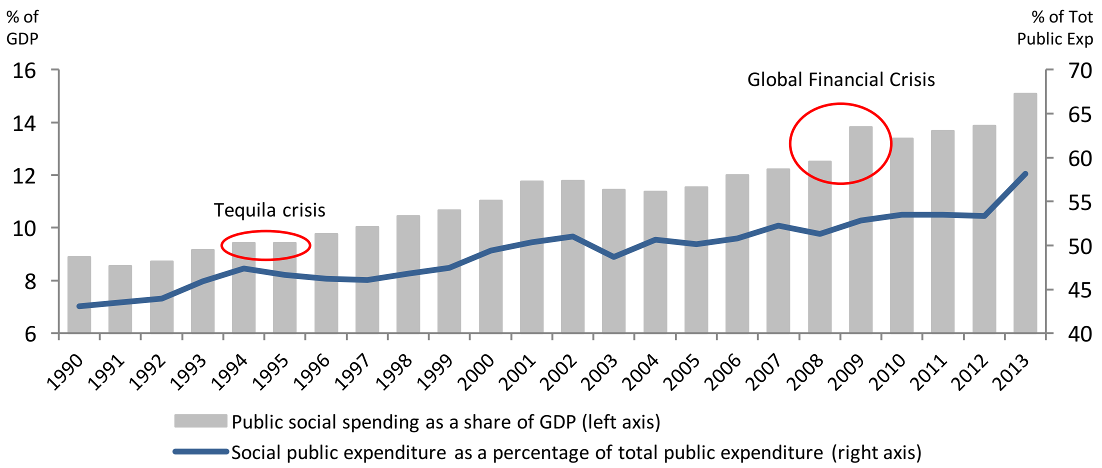
Low levels of tax collection are a characteristic feature of Latin American economies. Total tax revenue in Latin America went from 13.2% of GDP in 1990 to 21% in 2014. However, this ratio remains significantly below the OECD average throughout the period (**Figure 3**).

In Latin America, the weak fiscal collection relates to low proceeds from social security contributions (SSC) and income taxes, as well as from a tax structure mainly based on a regressive indirect taxation (CEPAL/OIT, 2015:27). **Figure 4** illustrates these dynamics: although the share of government revenue coming from SSC and income taxes increased since 1990, they remain considerably below OECD levels. In the first case, SSC seems to have attained a ceiling around 16%, which is closely associated with the high levels of structural informality in Latin America's labor markets and the impossibility for its fiscal systems to increase revenues by broadening the taxable base.

Given such difficulties in collecting taxes through these two mechanisms, most of Latin American governments have relied on indirect general consumption taxes to finance their expenditures. These types of taxes are easier to implement and manage, the downside being that they have a more limited reach in their redistributive impact. In Latin America, about 50% of total government revenues arise from General and Specific consumption taxes (31.3% and 17.8%, respectively), whereas this proportion is only 30% in OECD countries.

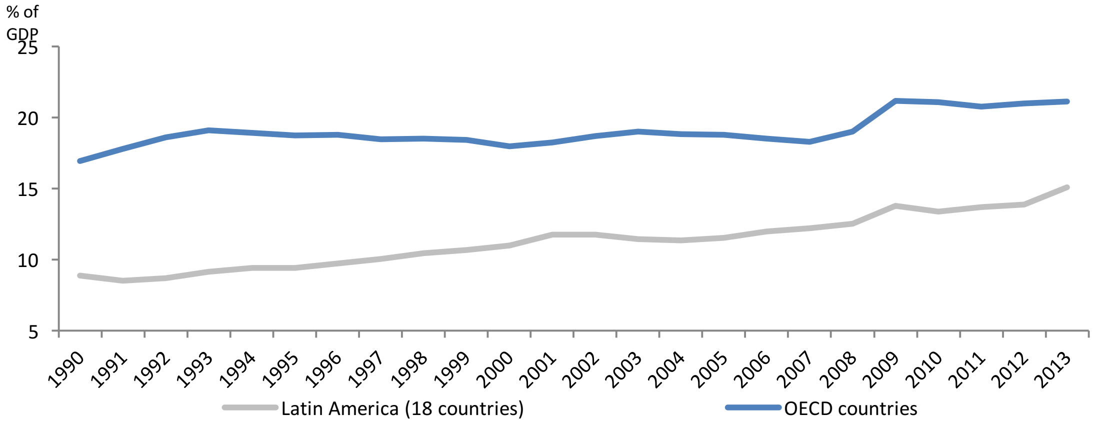
In summary, social security systems in Latin America have expanded their reach and size since the early 90s. However, they remain considerably undersized compared to OECD economies. This is explained in part by the limited government revenues which, in turn, relate to regressive fiscal structures and the impossibility of expanding the tax base using certain channels, for instance taxes on labor. On this front, the high proportion of informal workers in Latin American labor markets impedes the capacity of the state to collect taxes and, indirectly, the consolidation and improvement of its social security systems. We address this fundamental feature of the regional economies in the next section.

Figure 1. Public social spending as share of GDP and social public expenditure as a percentage of total public expenditure: Latin America



Source: Own elaboration on the basis of ECLAC Stats, accessed online at: http://estadisticas.cepal.org/cepalstat/WEB_CEPALSTAT/estadisticasIndicadores.asp?idioma=i

Figure 2. Public social spending as share of GDP:
Latin America (18 countries) and OECD countries

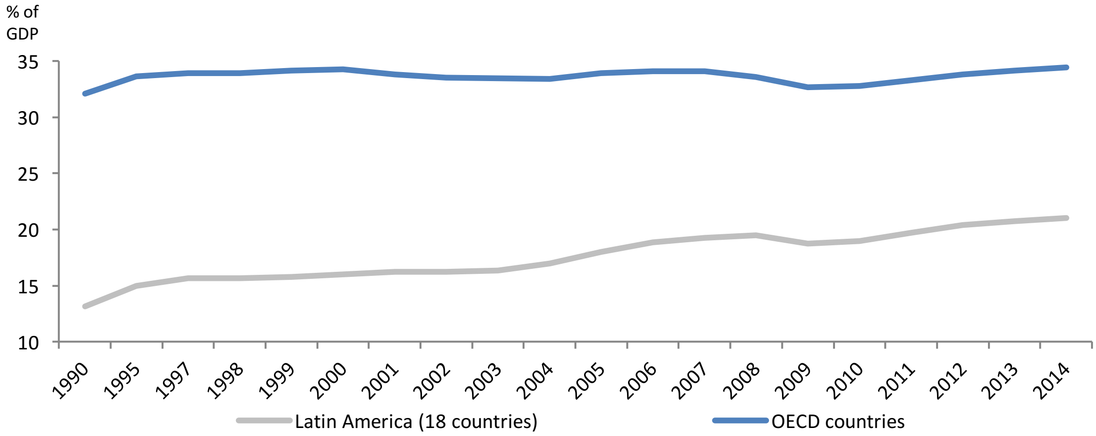


Source: Own elaboration on the basis of ECLAC Stats and OECD Stats, accessed at: http://estadisticas.cepal.org/cepalstat/WEB_CEPALSTAT/estadisticasIndicadores.asp?idioma=i and http://stats.oecd.org/index.aspx?DatasetCode=HS1988

Funding of public social expenditures

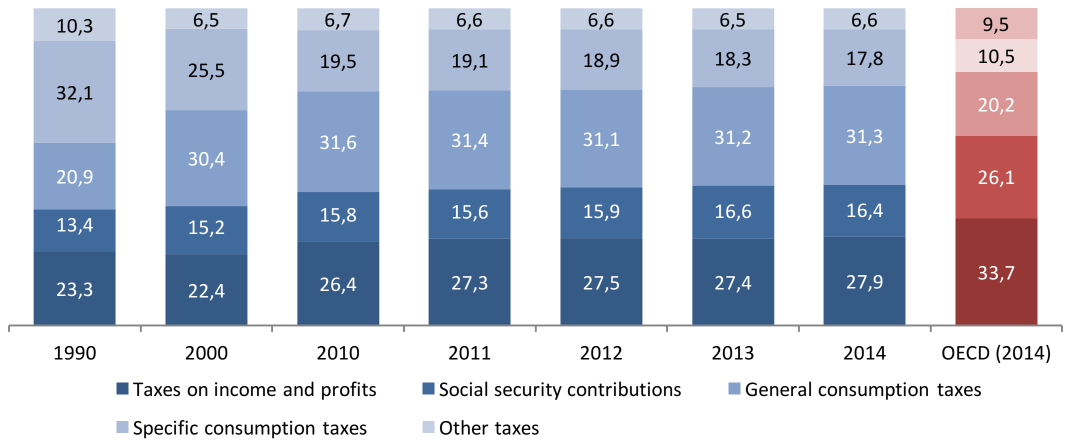
Figure 3. Total tax revenue as percentage of GDP, 1990-2014:

Latin America (18 countries) and OECD countries



Source: Own elaboration on the basis of OECD Stats, accessed at: http://stats.oecd.org/index.aspx?DatasetCode=HS1988

Figure 4. Tax revenues by type of tax as share of total government revenues, 1990-2014: Latin America (22 countries*) and OECD (percentage points)



* Latin America 18 countries plus Bahamas, Barbados, Jamaica and Trinidad and Tobago.

Source: Own elaboration on the basis of OECD Stats, accessed at: http://stats.oecd.org/index.aspx?DatasetCode=HS1988

3.1 Conceptual discussion on informality

Informality is a term used to define the "collection of firms, workers, and activities that operate outside the legal and regulatory frameworks or outside the modern economy" (Loayza, 2016:4). Consequently, labor informality describes the "jobs performed outside the formal structures that govern taxes, workplace regulations and social protection schemes (Huitfeldt, 2009:95). Since 20031, the concept of labor informality refers both to (i) jobs in the informal economy (defined by the characteristics of the production units) and (ii) informal jobs in the formal economy (defined by the specific characteristics of the job, such as no payment of SSC).

Regarding its causes, informality can be (i) the outcome of firms or individuals *exiting* the formal sector due to, among other factors, cost-benefit considerations or (ii) the result of agents being *excluded* from the formal economy as a result of its own particular structure and dynamics (Loayza, 2016:4).

Informality is therefore a complex and multidimensional phenomenon which is closely associated with some of the inherent characteristics of underdeveloped economies, particularly with low human and physical capital. As well, informality relates to the relation established between State and economic agents through the legal framework, enforcing and monitoring actions, and the provision and securing of essential services and rights.

Informality can be appealing to economic agents as it allows them to avoid the burden of taxes and regulations. However, participants face the disadvantage of being at the margins of the protection and services provided by the law and the State. In this sense, the implications of informality can be approached from two standpoints: First, from a labor rights perspective, it makes the full exercise of fundamental principles and rights on behalf of the workers difficult2. Secondly, from an economic point of view, informality promotes a misallocation of resources and limits the potential contribution of economic agents to the overall economy.

For what concerns our discussion, informality has an impact on the consolidation and expansion of fiscal systems through three channels:

1. On the one hand, it *directly* reduces tax collection as, by definition, informal agents operate outside of the fiscal framework. As a result, they do not pay their otherwise corresponding taxes.
2. Secondly, it *indirectly* decreases aggregate tax revenues by encouraging a less productive economy: informality relates to low levels of capital accumulation and slow labor migration to more productive sectors of the economy (Loayza, 2016:4), having as a result sluggish economic growth which, in turn, translates in lower tax collection.
3. Thirdly, informality represents an extraordinary burden for governments, as their participants demand access and the provision of social services from the State, but their working conditions exclude them from formal social security systems.

As a result, in an economic context with these characteristics, governments find it more feasible to finance their social protection systems by general revenues. Conversely, the downside of this funding strategy is an inefficient social expenditure allocation when it is combined with multiple social security schemes.

All in all, informality is one of the most pressing structural challenges that governments from developing countries face. Now, we will assess it in a Latin American context.

3.2. Informality in Latin America – evolution and structure

The most recent estimates of the ILO suggest that in Latin America there are approximately 134 million informal workers (OIT, 2016:39). However, when considered at a national level, informality in the region shows clear disparities in its evolution and magnitude.

Overall, informality rates show a positive downward trend during the past 25 years in Latin America. As we see in **Figure 5**, the most relevant reduction in the levels of informality took place between 2003 and 2013. This can be linked to a certain extent with the previously alluded incorporation of countercyclical policies and broad public employment programs within public social spending in Latin America. In turn, the financing of such extraordinary government expenses was possible due to a positive international economic environment with high commodities prices and an excess of liquidity in global financial markets.

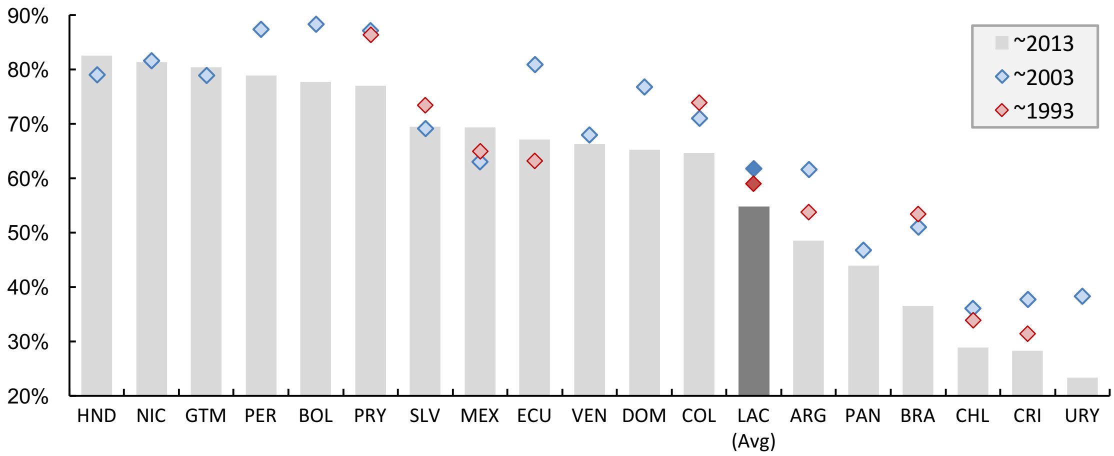
On average, over one out of every two workers in Latin America is informal (54.8%). However, this average hides significant disparities among Latin American economies. Whereas countries such as Honduras, Guatemala and Nicaragua have the highest proportion of informal workers in the region (above 80%), others like Chile, Costa Rica and Uruguay have informality rates below 30% (OECD/CIAT/IDB, 2016:33).

Within countries we also see sharp differences in informality rates when considered by level of income: for all countries, informality is significantly higher for the first quintile and tends to fall as income increases (**Figure 6**).

In retrospect, although informality is a persistent problem for the region, it has reduced in the past two decades. However, significant disparities can be observed across countries and within countries (when considered by income level), one common trait being that it mainly affects the most vulnerable and poorest members of the population. This last feature of informality in Latin America is of key relevance for the sustainability and effectiveness of its social security systems.

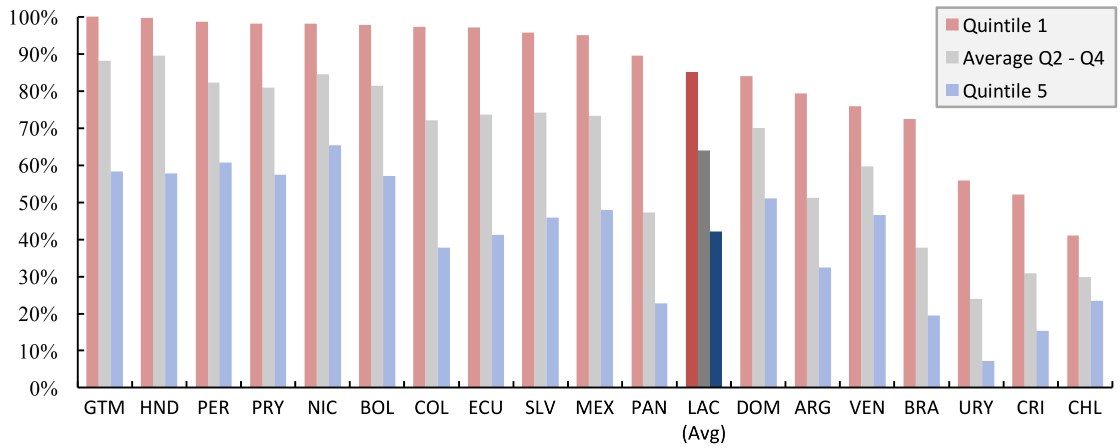
ILO reports that after a decade of sustained reduction, informality levels in Latin America increased during 2015 and 2016 (OIT, 2016:39). In order to address these high levels of informality, Latin American governments need to develop policies that effectively approach it both as a structural component of their economies and as an urgent socio-economic concern to be solved. We conclude by discussing these issues in the next section.

Figure 5. Informality rate in Latin American countries:
Percentage of workers NOT contributing to social security- aged 15-64 years



Source: Own elaboration on the basis of OECD Stats, accessed at: http://stats.oecd.org/index.aspx?DatasetCode=HS1988

Figure 6. Informality rates in Latin America by quintile of per capita family income, 2013:
Percentage of workers NOT contributing to social security- aged 15-64 years



Source: Own elaboration on the basis of OECD Stats, accessed at: http://stats.oecd.org/index.aspx?DatasetCode=HS1988

4. Concluding remarks and policy implications

Informality is a complex and multifaceted socio-economic problem with transcendent implications for the design and implementation of economic and social policies. We have seen how the trends of informality in Latin America have changed as a consequence of fluctuations of the general economic environment, and as a result of the implementation of public policies intended for this end.

Nowadays, over one out of every two workers belongs to the informal sector in Latin America. Furthermore, the downward trend in informality experienced by the region during the first decade of the 20th Century seems to have halted. As a result, recent estimations show an upsurge of informal work in 2015-16. The burden posed by informality on both the economic development and social conditions of the population, challenges the governments ability to cope with the soaring social demands as it severely limits is fiscal consolidation.

On the one hand, it is fundamental that policies intended to combat informality operate on a parallel, two-layered timeframe. Firstly, in the short-run, policies should be addressed to streamline regulations and strengthen monitoring and enforcing actions. Secondly, long run policies should target structural limitations of the economies, for instance, providing and improving public infrastructure, services and institutions, and supporting human capital formation.

Regarding our discussion, the implementation of the first type of policies would *directly* contribute to increased tax revenues, therefore providing governments with extraordinary resources to address the demands of the most vulnerable population regarding social security. The second type of policies would *indirectly* improve the fiscal situation of the state in the long run, as it would increase the overall productivity and size of the economy by triggering economic growth.

However, the success of any public policy addressing informality depends to a great extent on having an integral approach to the issue and therefore not relying only on one specific type of strategy, dimension or timeframe. For instance, if informality was simply considered by policy makers as a problem of weak enforcement, the resulting policies risk only focusing on strengthening monitoring and increasing sanctions. Conversely, this approach risks ignoring that many people rely on informality as their only means of subsistence. On the other hand, if informality was conceived as a problem of streamlining normativity and regulations, ensuing recommendations could, on the most extreme cases, argue in favor of simply lifting any apparently inefficient regulation. In both of these cases the structural component of informality would remain untouched.

On the other hand, a policy approach focusing exclusively on the systemic character of informality would risk addressing it only as a problem of limited capital accumulation and slow Total Factor Productivity (TFP) growth. Such a approach would certainly prove effective to reduce informality in the long-run, but it would leave unattended some of the most pressing problems that informality implies for a significant part of the societies today, for that reason being politically and practically unfeasible.

In general terms, “informality derives from both lack of development and biased policies” (Loayza, 2016:28). In the case of Latin America, informality is both a cause and a consequence of the regional process of economic development.

After several decades operating under a neoliberal agenda, the Latin American outcomes have proved limited when compared with the original objectives. This scenario leaves the States with outdated and limited institutional and operational capacities no longer fitting the social demands, for what concerns social security systems.

Analyzing informality and social security systems in Latin America exclusively from the field of the orthodox economy fails to provide an accurate response. By assuming informality as a multidimensional economic process and placing it in the complex socio-economic context of Latin American countries, other aspects of the most diverse nature emerge. For instance, the morality of informality and its impact in the long-term well-being of societies imply recovering and reinforcing the role of the State as guarantor of social and economic rights.

A first compulsory step for the governments in Latin America is to revisit their social policy and institutions. This exercise will allow them reconsider the current financing scheme of multiple social security systems, and assess the need and benefits of building a less intricate and more efficient system that guarantees effective access to social security to its entire population regardless its labor status.

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