

**Informal Labor Market, the  
“Invisible” Elephant in  
Mexico:  
Will Pension Reform Get Rid  
of It?**

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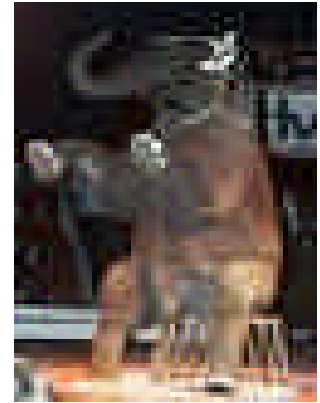
and

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# Story of Benny, the elephant

- In March 2000, a three-ton Indian elephant (*Elephas maximus*) named Benny was smuggled into Mexico from Texas.
- For nine months, Benny performed circus tricks like playing the harmonica and riding the bicycle.
- Indian elephants are endangered species.

# Benny

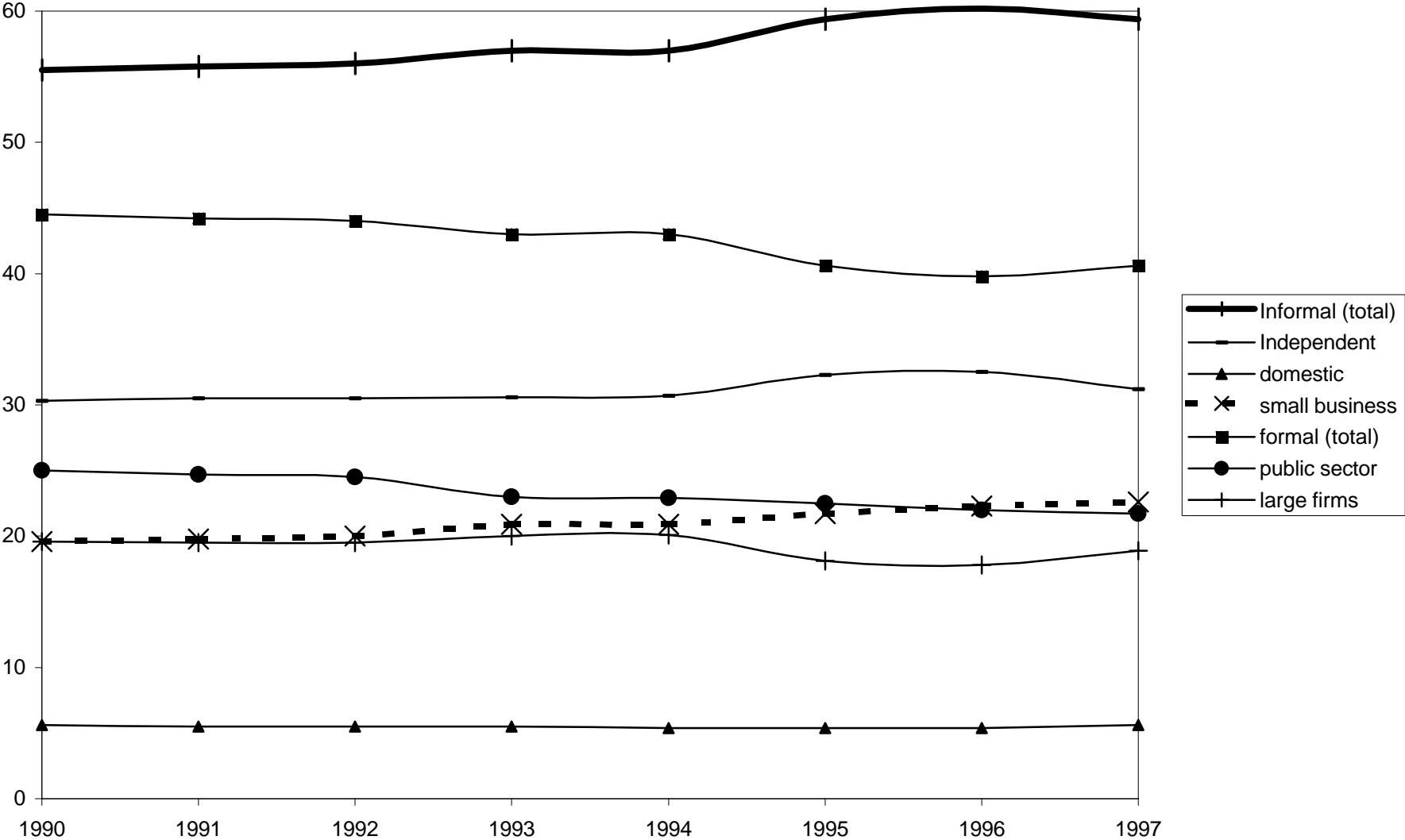


- It is illegal to smuggle them to perform in a circus.
- Yet, nobody "saw" the elephant crossing the border
- Apparently the custom agents were paid US\$4,500 to make him "invisible"
- Benny is an apt metaphor for the informal sector in Mexico

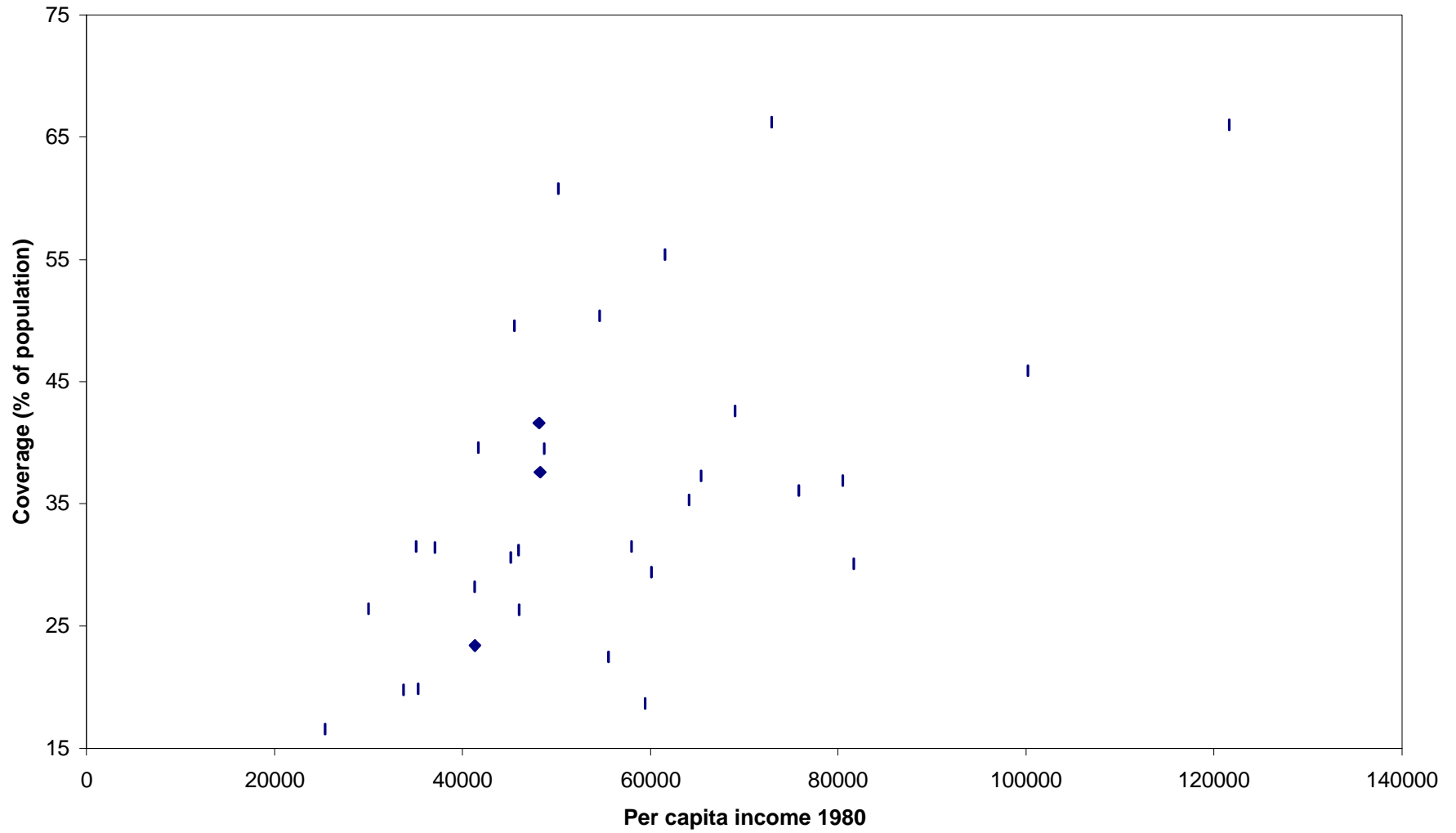
# What is the informal sector

- What exactly is the informal sector?
- Two Classifications according to
  - The type of technology employed.
  - Whether or not taxes are paid to the government.
- Informal sector is very large in Mexico as well as in other Latin American countries

Sectoral breakdown of employment in Mexico



### Coverage and Income



| Series1

# Informality according to INEGI

- National Employment Survey (of INEGI) uses three characteristics to define a worker in the informal sector.
  - (1) Employed in an establishment with five or fewer workers.
  - (2) A self-employed person.
  - (3) Employed without any employment benefits.
  - Unfortunately, none of these characteristics necessarily measure informality

<i>Type of work</i>	<i>Number</i>	<i>%</i>
Without working locale	16,944,413	43.37
From door to door	942,972	2.41
In a vehicle	998,460	2.56
In home	7,142,781	18.28
Semi fixed stand or market	474,485	1.21
Other	7,385,7151	8.90
With locale	22,124,682	56.63
Small	6,654,326	17.03
Medium and large	15,309,078	39.18
Other	151,266	0.39
Not specified	10,012	0.03
TOTAL	39,069,095	100.0



## **Working Conditions in Mexico**

<i>Types</i>	<i>Number</i>	<i>%</i>
Without benefits	24,917,705	63.9
Only social security	430,959	1.11
Social security + without social security	12,243,132	31.44
Not specified	9,043	0.02
<b>TOTAL</b>	<b>38,939,037</b>	<b>100.00</b>

Data: INEGI, 1999

# Types of Contract in Mexican Labor Market

<i>Contract</i>	<i>Population</i>	<i>%</i>
<b>With contract</b>		
For indefinite time	11,200,023	47.13
Less than two months	493,821	2.08
From 2 to 6 months	549,692	2.31
More than 6 months	734,963	3.09
Not specified	101,784	0.43
<b>Without contract</b>		
Verbal contract	10,666,559	44.89
Other type	7,165	0.03
Not specified	9,577	0.04
<b>Population with salary</b>	<b>23,763,584</b>	<b>100</b>

Source: INEGI, Encuesta Nacional de Empleo, 1999

## *Salary Structure by activity (multiples of minimum wage)*

<i>Activity</i>	<i>total</i>	<i>&lt;1</i>	<i>&lt;1&lt;2</i>	<i>&lt;2&lt;3</i>	<i>&lt;3&lt;5</i>	<i>&lt;5&lt;10</i>
Agriculture	21.05	5.88	4.46	1.10	0.50	0.30
Industry	18.62	2.86	7.16	4.01	1.88	0.84
Electricity	0.49	0.01	0.09	0.16	0.15	0.05
Construction	5.50	0.48	2.65	1.35	0.54	0.18
Trade	16.86	3.39	5.20	2.56	1.55	0.66
Hotel	4.63	0.81	1.71	0.69	0.40	0.17
Transport	3.96	0.27	1.03	1.21	0.78	0.38
Communications	0.50	0.03	0.15	0.13	0.09	0.01
Professionals	3.74	0.25	0.98	0.79	0.79	0.47
Services (other)	19.31	4.49	5.81	3.29	2.95	1.55
Public Service	4.43	0.18	0.92	1.45	1.00	0.54
Unknown	0.42	0.01	0.02	0.02	0.04	0.13
<b>Total</b>	<b>100.00</b>	<b>18.69</b>	<b>30.24</b>	<b>16.85</b>	<b>10.78</b>	<b>5.43</b>

# Problems with the informal sector

- People in the informal sector have lower standard of living than in the formal sector.
- Government raises taxes
- It falls on the formal sector
- Tax finances public goods
- Concentrating government taxation in the formal sector
- Reduction of efficiency

# Two proposals

- Two proposals to eradicate the informal sector have been suggested
- Proposal 1: Identify and tax the informal sector (Ihrig and Moe, 2000)
- Proposal 2: Move to a fully funded pension system
- We are skeptical about the first proposal

# Why?

- The first proposal assumes that informal sector workers do not pay anything
- Participants in the informal sector *do* pay taxes (in the form of bribes), although not to the government
- Not all heavily tax countries have such large informal sectors (for example, Denmark or Sweden).

# Mexican example

- The Mexican government unveiled a program (in October 1999) to tax the economy's informal sector.
- Authorities expect at least 1.5 million street vendors and other small-scale retailers to become part of the tax base by October 2000.
- This looks like the implementation of the first proposal!

# What about proposal 2?

- Would a fully funded system alleviate the informality problem?
- Serrano (1999) says yes
  - “Our thesis is that many poor workers will obtain access to the formal financial system through the privatized social security system. ... The introduction of an obligatory FF [fully funded] system may give these people access to the financial system (p.3) ”
- The question of course would be, why could not the regulatory authority eliminate this restriction under a pay as you go system?



# Why do people *really* work in the informal sector

- If not tax avoidance, why work in the informal sector?
- Two facts
- The informal sector requires of less capital intensive technologies
- Barriers in the capital markets make the acquisition of capital scarce and relatively expensive, see Jones (1994)

# The main action: friction in the capital markets

- Why else could a fully funded pension system lead to a migration from the informal to the formal sector?
- What if the FF system led to higher returns to the pensioner?
- Would this act as a magnet?
- The relevant comparison is between the returns in the two FF systems; the informal and the formal system

# Moving to a fully funded system

- Two factors to include in this estimation
  - A true transition to a FF system requires sooner or latter of higher taxes to finance the retirees in the pipeline
  - The current pension system has high transaction costs
- Something else to take into account
  - even if the comparison favors the return on the formal FF system, unless capital market barriers are removed, the magnet will not work
  - If Irhig is correct and taxation is the driving motivation to become informal, a formal FF system will work against an elimination of informality

# Parente et al model

- This model requires two ingredients
- The informal sector requires of less capital intensive technologies
- Barriers in the capital markets make the acquisition of capital scarce and relatively expensive
- Are these ingredients relevant for the Mexican market?

# Where are all the informal sector workers in Mexico?

- Large number of informal sector workers are in agriculture, services and trade
- It is well-known that except for large scale farm production, most agricultural activities are of low capital intensity
- Many traders (tacos from the back of the bicycle) are activities of low capital intensity
- Services include workers as maids etc.

# Frictions in Capital Markets

- Bankruptcy laws are very weak
- It is difficult for the lenders to foreclose in case of default in loan repayment.
- This increases the risk
- If this barrier can be lowered or eliminated, it will encourage people from the informal to the formal sector

# Why do frictions appear in the first place?

- It may be government induced.
- Government might force the banking sector to buy debt at below market rate
- This would induce a higher price for all others using the banking service (by producing a wedge between the borrowing and lending rates).
- Bad credit bureau: banks do not know good risks from bad

# Prescription

- Identify the barriers that arise in the capital markets
- Set up policies that would lower these barriers
- This will create a movement from the informal sector to the formal sector