Workers of heterogeneous ability and fiscal structure: possibilities for fiscal reform in Mexico

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Summary

The existence of a large informal labor market—a population formed by those not paying taxes or social security contributions, yet receiving social benefits—is a major issue for taxation and social protection policies. Why do some government policies seem to increase the cost to workers and firms for entering the formal economy? A model explaining the behavior of the government assumes that workers differ in levels of ability and thus tax-paying potential, but this is private information. The government is not able to observe skill levels and faces the classical dilemma of social policy: generous social benefits may discourage workers from displaying the optimal level of effort, but it is not easy to distinguish the “deserving poor” from the lazy. To preclude a low-skilled worker from accessing a high wage contract, he is discouraged from delivering an optimal combination of effort and productivity. Thus, low-skill workers look lazy and receive social benefits that comprise a relatively large portion of their income. The proposed model incorporates endogenously the efficiency cost of taxation, which seems to be very high and a limiting factor for the expansion of social expenditures. We discuss the potential range of the welfare cost of taxation given the main features of the Mexican labor market, and also the options for fiscal reform given the framework observed in OECD and Latin American countries.
1. Introduction
This article deals with two issues in fiscal and social policy analysis: the informal economy and the level of tax collection dedicated to finance social programs. It is often stated that the Mexican economy has a significant level of informal economy defined through jobs not generating tax payments, particularly those related to social security; and that the level of tax revenues as a share of GDP is low compared to other OECD countries and even Latin America.

Our main contribution is to explore the hypothesis of “endogenous segmentation of the labor market”. If it is costly to know the true productivity of workers, the government can split them into groups according to their observed productivity to reach an optimal level of tax revenues. More productive work operates efficiently, but low productivity individuals are motivated to make less-than-best effort. This separation is the best way in which the government can optimize tax revenues while delivering a social benefit. The tax and benefit program is a mechanism, a contract, that induces individuals to reveal their true skill level. The segmentation of the labor market is a deliberate division induced by the government to streamline its financing and balance social benefits delivery goals, part of a revelation mechanism.

In this model we can interpret stratification as the definition of sectors with varying degrees of formality. Workers receive tax-benefit packages according to their ability. Some can receive the benefit of paying low taxes and a revelation mechanism leads them to work inefficiently: they look much like one of the most common definitions of informal workers because they have low productivity and pay little taxes compared with their potential.

A related definition of informal work says that informality exists when skills have different prices in various sectors. Alternatively, if two seemingly equal workers get different wages in different types of job, there is rationing and it defines informality. In our argument, workers are separated according to unobservable characteristics: a low-productivity individual opts to take a subsidy, avoids paying taxes, and performs at a lower effort level rather than moving to a job for which an external observer (i.e. the government or an econometrician) considers him qualified.

Schneider (2004) finds a strong statistical relationship between informality and low economic growth, a high burden of taxation and high unemployment. The United States, Switzerland and Japan have the smallest shadow economies, at half the level estimated for Germany or France, and one-third of the values found for Greece, Italy
and Spain. Mexico has a level of 30%, similar to Korea at 27% and between Chile and Brazil, which are at 19% and 40% respectively. Thus, the issue of stratified labor markets is not exclusive to developing economies.

Kuehn (2007) observes that 16% of the product in countries of the OECD was produced informally in 2001-2002, and she aims to model the interaction between the tax system and workers’ abilities as a factor to generate informality. In her model, tax rates are critical but not sufficient to explain the phenomenon. The quality of governance, defined as the degree of compliance with the tax law also plays a role, and so does the skill distribution in the economy. The low-skilled individuals work as subordinates, those of average ability are administrators in the informal economy, and the highly skilled individuals end up as managers in the formal economy. Thus, the highest-skill individuals are bosses in corporations, the medium skilled are informal small and mid-sized entrepreneurs, and the rest are salaried workers, being indifferent between working in one environment or in another. In our model, stratification is also correlated with skills, but we only have two types of workers.

Sanchez-Vela and Valero’s model (2010) also indexes workers according to their level of ability: low-skilled workers become employees and high-skilled workers become employers, and the number of employees in a firm increases with the ability of the manager. In their paper, an approximation to Mexican tax laws is developed, and the distortions generated by the tax law are estimated taking the U.S. size-distribution of firms as the benchmark.

Compared to the Kuehn’s (2007) paper, Sanchez-Vela and Valero (2010) are more concerned with modeling the selection of small firms into the alternative fiscal regimes existing in Mexican tax law—we comment on this later. In both cases, researchers use the cost of auditing and the lack of skilled managers in the informal economy to produce an informal sector. Their analysis differs from ours in that our model aims to explain the behavior of the government as provider of a package of social benefits to all, requiring taxes on labor income to finance benefits, and minimizing the associated distortions. In the absence of a social program objective, the model of this paper has high- and low-income workers, but no inefficiency. Their models are not at odds with ours, they only deal with a different issue.

In the next section, we present a summary of some of the major innovations in fiscal policy related to labor market informality. Later, we present arguments on why segmentation of the labor market has been used to mix progressively extracting taxes
from the working population and delivering social benefits (section 3), present information on the main tax trends in OECD and Latin American countries (section 4), and conclude with some considerations on the causes and effects of informality.

2. **Why is the government not looking for a policy to reduce segmentation?**

Can informality decrease (i.e. is it possible to achieve higher levels of affiliation to social security and a larger tax base through policy changes)? Why has it not been possible for the government to achieve fiscal and social policies to eliminate the segmentation? Segmentation has two sides: some pay taxes and some do not, but also the benefits packages differ across populations. Arguments on why segmentation is bad have to do with both sides. Discontinuities in the restrictions faced by firms and workers define high marginal taxes on the growth of firms and motivate an excessive frequency of micro-firms, reducing overall productivity (Anton, Hernandez and Levy 2012). Also, broken health and pension systems encourage moral hazard and limit the ability of the state to succeed in its goals of reducing inequality (Aguilera, Miranda and Martinez 2012).

Yet, it seems that some policies actually move in the direction of strengthening the segmentation. Consider a recent policy event that alters the rates of taxation on self-employed labor—the introduction of an “entrepreneurial flat rate tax” (IETU). This is a minimum tax on firms and professional services providers. The mechanics of the tax is the following: first, firms (self-employed individuals and also corporations) calculate the taxable base for the traditional income tax (ISR) and apply a relatively high rate (30% in 2010-2012); second, they calculate the taxable base for the IETU, which is the same as the ISR less most labor costs, and apply a lower rate (17.5% since 2010) to define tax liabilities.

Graph 1 illustrates the effect to a hypothetical case where firm inelastically have sales of 2 and costs equal to 1, but with shares of labor costs may vary from 1 (only labor costs) down to zero (no use of labor). With the ISR, the average tax rate is the same in all cases, but with the IETU, labor intensive firms face a higher average tax load (taxes are given by the maximum of both functions). On the right side, we see that labor intensive firms are affected negatively. In fact, the IETU is a tax on labor ranging from zero in capital-intensive firms, to an increase of several percentage points in the marginal tax for workers in labor-intensive firms (1.9 points in the chart that corresponds to the 2010 tax rates, for a firm with only labor inputs).
For our discussion, we have to also consider the mechanism of “small taxpayers” usually known as Repecos (after Régimen de Pequeños Contribuyentes). These are defined through having earnings below 2 million pesos annually (around 130 thousand dollars in 2009-2012). In principle, small taxpayers pay all taxes; in practice, with the aim of simplifying accounting and collections, local authorities (i.e. municipalities) calculate a fixed fee to cover income, entrepreneurial and value added taxes. This is done on a case by case basis with information provided by the private party, through an estimate of sales. In other words, under the Repeco regime the municipality calculates an average rate of each tax according to the self-declared history of the small firm or individual. This feature of the tax laws seems to be drafted under the hypothesis that average earnings and taxes can be calculated except for random variations.

However, systematic deviations in the application of the laws across states can be forthcoming because each state or municipal authority in charge of the calculation has an interest in reducing the tax load for local small firms and self-employed workers (possibly due to local politics considerations). Tax-payers may act enrolling into the general tax scheme, into the Repeco, or remaining in the informal economy. Thus local governments do not have a full incentive to carry out tax collections because they do not receive all the collected monies. This is a form of share-cropping, a “tax farmer” arrangement; local governments hold police power against small firms, derived from
federal legislation, but they do not obtain full benefits from collections. Even if they were to internalize fully the value of the public collections, they would face the problem of selection between the general regime and the Repeco (namely, high productivity small firms prefer to stay Repecos).

As far as we have been able to find, there is no information on the number of firms or individuals affiliated with the tax system through the Repeco regime. Certainly, the ability to carry out a comprehensive measurement of the program is absent because each state has the power to set tariffs for each contributor. There are federal guidelines but there is room for discretion in measuring revenues and costs, and there is no federal system of information to record transactions at the point of inception—state governments carry out this process on a shoebox basis. The federal authority eventually finds out about part of the transactions when tax payments are received or when a taxpayer makes use of a bank, but as far as I can tell, there is no requirement of reporting information on the calculation of the tax fee by states or municipalities.

The strategies to collect taxes from small firms and the self-employed are part of the general approach to obtain revenue for the government. To gauge the potential to collect taxes over time, Graph 2 shows the evolution of tax rates since 1980. The big trends are as follows: a) towards the end of the 1980s, income tax rates decreased while the value added tax and social security contributions increased; b) from the 1990s onwards, rates of contributions to social security decreased, while the value added tax (VAT) and the ISR increased; and, c) the government responded to recessions in 1981-1983 and 1994-1995 with increases in the VAT, and during the 2007-2010 recession it has raised taxes by means of the IETU, the VAT and the ISR.

Graph 3 shows federal tax collections from 1980 until 2009. Collections have been generally stationary, with the exception of those corresponding to income taxes.

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1 Do we have space for a solution on the lines of Cheung (1969)? By this I mean that the Repeco regime really may not matter much, that the federal government would not be obtaining a significantly different amount of resources from taxing each small firm on actual sales instead of taxing on an historical average of those voluntarily submitting to the law. Probably, the issue of high-productivity small firms opting for the Repeco regime is not empirically important or local governments prefer to comply with federal legislation above favoring local employers. Also, local authorities may negotiate with local small business to share the benefits on cheating on federal rules, reducing the negative externality.

2 Taxpayers show local authorities their compilation of receipts for validation.

3 The federal government knows about sales if deposits are made in a bank. In fact, a new tax on the use of cash was enacted in 2008 (reference). Any registered tax payer receiving over 25,000 in monthly cash deposits (around two thousand dollars) is subject to a two per cent tax that can be credited against other federal tax liabilities.
which vary more with the business cycle. Yet taxes on sales had fallen considerably during recent years as a consequence of subsidies to energy—a sort of industrial and social policy. The decline in contributions for social insurance by the mid-1990s reflects only an accounting change because of pension reform that redirected some cash flows to private fund managers while keeping long-term public liabilities roughly intact. The decrease in social security contributions starting in 2001 is associated with low growth of employment covered by social security compared to the growth of the economy—namely, an increase in the informal labor market. Income and sales taxes collections are highly cyclical (see the fall during the 1995, 2001 and 2008-2009 recessions).

In short, the government attempted higher tax rates in the eighties but collections did not respond favorably. When the government has cash flow problems it inclines towards increasing tax rates. The most recent reforms—arising during the Great Recession—have moved in the direction of extracting more from the labor-intensive tax payers (i.e. higher IETU and ISR rates) and from consumers (increase in the VAT rate), while maintaining the Repecos regime for small and medium-sized firms (as described by Sanchez-Vela and Valero 2010).

On the benefits side, the federal government’s plan has been explicit on the purpose of displacing social security in favor of non-contributory schemes (Knaul et al 2012). Between 2000 and 2010, the projected ratio of per capita public expenditures on health between contributors and non-taxpayers would pass from 2.5 to 1.5 times (Seguro Popular 2006). Our calculations show that by 2010 this ratio was in fact 1.5. Expenditures per capita for tax payers were around 4.6 thousand pesos, while expenditures on non-tax payers were around 3.0 thousand pesos. The figure for contributors includes payments made by firms and workers, and the government share is slightly above 20%. Thus, the policy sets federal funding for health services that aims to equalize the gap between average expenditures between the families of taxpayers and other families.

How to make the variety of state attempts to improve tax-benefits schemes compatible with the welfare goals? In the next section we discuss a model that allows the government to deliver progressive social benefits in the least costly way. A main

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4 For a few decades all the money in individual retirement accounts will return to public coffers to pay for public pensions.
implication is that low-skilled workers are discouraged from putting out their best effort.

Graph 2

Tax rates in Mexico 1980-2010

- Purple: VAT
- Red: Maximum income tax rate on individuals
- Green: Average employer-employee social security tax
- Blue: Maximum income tax rate on corporations
3. Stratification of the labor market to sustain the welfare state

*Why the government separates workers*

The model presented in this section creates a stratified labor market in the following sense: the government has the goal of giving a social benefit to all (possibly the same value of benefits or a minimum level of consumption). The government is progressive so there is a collective agreement to charge a higher share of the cost of benefits to higher income individuals. This creates a problem, because some individuals, knowing that they are entitled to a benefit, may decide to save on their personal work efforts and become “undeserving poor”. The government would like to see directly the productive capacity and the cost of the labor effort for each individual, but by assumption it is not possible. Thus the government ends up defining a framework with taxes and benefits that differ according to observed productivity.

The argument as to why the market ends up stratified is that: 1) if wages and benefits are the same for everyone (which can be achieved through taxes and subsidies), those who are more productive may not be very interested in making their best effort (that is, the marginal cost of their effort would be below their marginal productivity); 2) consequently, a better contract will pay a little more to a more productive worker, but this runs the risk of enticing also the low-productivity worker to exert more effort to collect a higher wage, while a high-productivity worker may decide to compromise on
work effort to appear as a low-productivity individual, saving the cost of personal effort and receiving the social benefit anyway; and, 3) the difference in wages between the two types of workers has to be large enough to provide incentives to the more productive to continue working at their best potential, while preventing a low-productivity worker from appearing as a high-productivity individual (to collect a higher wage) through the imposition of a requirement of effort level that is too costly to achieve. Thus, the wage premium has to be large enough to induce the more skilled to do their best effort, and the production goal has to be large enough to make the less-skilled face an effort level that is too steep.

Following the framework developed by Laffont (1994), the worker has a total cost of work that is the sum of a monetary cost and a non-monetary cost. For the worker, utility is a function of the subsidies he receives, plus the net income before subsidies, less the cost of effort. In other words, the effort exerted affects utility in two ways. First, effort is a flow that reduces marginal cost. Second, effort induces a utility cost that is increasing because to devote more time to work a person uses skills less efficiently (e.g. physical fatigue, mental limitations). Individuals also have preferences over consumption and leisure that determine labor supply.

The government views the taxation-subsidization decision in the following way: it is optimal to obtain more tax revenue from individuals or firms with more inelastic labor supply or demand. With an exogenously defined level of subsidies (for example, due to preferences for equality), an optimal tax schedule can be defined (Mirrlees 1971).

However, when information on the productivity of the worker is private information there is a clash between the goals of the state and individual preferences. To some extent, the government may incur in costs to audit the financial flows of individuals to define taxes, but it may face a high marginal cost of doing so. When workers have different skill levels that are not observed by the government, and the government has progressive goals (for example, reducing the variance of consumption across families or defining a minimum level of consumption), individuals have an additional reason to hide their true skill level. Namely, observed productivity is the result of skill and of costly effort, and the consumption guarantee opens up a window to shirk, reducing effort with a high marginal cost and tax liabilities.

There are several ways in which the information available to the government may be less than ideal for designing a program of tax and subsidy: the government may not know the distribution of skills, or it may know the distribution but not the location
of individuals, and there may be limits in the capacity to audit costs. The inability to observe costs and audit them is probably more significant when dealing with individuals than with corporations, and when there are fixed costs of accounting and auditing. This seems to coincide with the most basic idea of what informal work is: high costs of governance of tax laws and of social programs, with heterogeneous worker skills that are not always easily measured by the government.

When costs cannot be observed because accounting is not reliable, and consequently audits are not trustworthy either, the government can only use information on transfers and levels of production to design the tax-subsidy schedules. Even this can be an optimistic assumption because for small firms and independent workers there is a cash economy and even measuring cash flows may not be easy.

Unable to verify cost, the contract offered by the state reduces the work of the least skilled through lower pay and lower effort. Low-productivity workers end up with fewer hours of work in comparison with a framework of complete information. This agreement makes less skilled workers appear, additionally, lazy. The effect on subsidy on the income of the low-skilled workers financed with a tax on labor earnings is lower wages and reduced effort. Heuristically, high taxes and subsidies can motivate some workers of higher skill to show themselves as low-productivity individuals, collect the benefit and save on effort. To limit this excess burden and balance it with the benefits of a more equal society, the state has to allow more skilled workers to earn more, in a difference that compensates them for their higher effort (and makes it too hard for low-skill workers to do the effort to earn more).
How does the labor market look?

In an economy such as this, we will see high-earnings and low-earnings workers, and the government providing cash transfers that are proportionately more important for the low earners. If there were only two types of workers, namely, if everyone is equal except for a productivity parameter, we could think about the decision-making process of the government in the following way. It defines two wage rates, and starts from levels of earnings and production goals equal to all and equal to the reservation wage of the low-skilled (the government knows the productivity of the less-skilled); defining then a gradually increasing gap, until the group of high productivity workers splits out. Then, the government has found the reservation wage of the high-skilled.  

The actual process of search for an optimal tax-benefit structure is complicated by the heterogeneity of workers (there is a dense distribution of skills), because labor supply depends upon other factors and the government would like to use them to define the subsidies (i.e. workers differ in their financial and social wealth and in other aspects), and because the distribution of skills is not known. Due to these issues the form of the tax system is not irrelevant and can alter significantly the analysis according to conventional arguments of public finance. For example, if the government decides to set a flat tax on the payroll and give an equal benefit to all persons we will obtain a different pattern of distortions from one obtained with a progressive tax schedule. In Mexico, part of the ongoing debate on fiscal reform has to do with shifting to a mix with lower contributions on social security.

Thus, the history will probably be one of an always segmented labor market, with government attempts to improve on the definition of tax-benefit schedules, always trying to extract a little bit more from the high-skilled workers, increasing the general social benefits of the benefits targeted to the low-skill workers. I believe this is a significant narrative around Graphs 2 and 3.

How important is the social cost of taxation?

The deadweight loss of taxation is an endogenous variable, and the variations in that quantity can have a large impact on hours worked and wages. There is little research on the efficiency costs of the fiscal system (Levy 2008, p. 161). Nevertheless, a

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5 There is a possibility of all workers shifting to the high wage contract, in which case the government has to define higher production goals for the more skilled, until the cost of effort of the low-skilled workers makes them prefer revealing themselves as low-skill.
computation using the models by Dahlby (2008) is shown in Graph 7, as a prior of the probable marginal value of fiscal costs.

If the elasticity of supply of capital is very large—which is probably true in the long-term, particularly in a small economy like Mexico—the marginal cost of tax funds can be above 60% and reach 160% for tax rates above 30% and an elastic labor supply. The upper boundary seems to be an acceptable value compared with the references of Jones, Tandon and Vogelsang (1990) and Dahlby (2008). While OECD (2005) and the government of Mexico consider a source of inefficiency the low level of tax revenues compared to other OECD countries, it is possible that the high marginal cost of funds is the cause of the failure of the several tax reforms tried since the nineties. Also, notice that these figures refer to marginal cost of taxation measured at the individual level; diversifying the sources of federal income and cushioning the effect of taxation through allowable deductions and other tools of the tax code have as main goal to eliminate the events of extremely high marginal cost.

Labor supply is very inelastic at the intensive margin (Martinez 2012), but little is known about the behavior at the extensive margin. However, we can see in Graph 7 that the marginal cost of funds grows exponentially with the tax rate; for tax rates above of 30% and an elastic labor supply, the marginal cost is so high that it costs more to collect than the value of collections, so only a very large productivity of public expenditures would justify tax increases.
It can be mentioned that South Korea and Chile, possibly the two countries with labor markets more similar to Mexico within the OECD, actually have similar levels of tax revenues and, in particular, levels of taxes on labor. These two countries have followed social policies more oriented towards decentralized solutions than Mexico.

Finally, it is not easy to see in the model a way to eliminate distortions by abandoning payroll taxes. A consumption tax would be very similar to the payroll tax, and if the supply of capital is very elastic, possibly the economy does not have options to finance social spending increases without entering regions of high tax inefficiency and large disincentives to work. Existing policy proposals to shift from taxes on labor to taxes on consumption aim to move the source of cash flows to the state from the payroll to the consumption market. In our framework, these views recognize that existing sources of funds (income and social security taxes) have a very high marginal cost, and propose using more the general consumption tax, to a good extent assuming that tax evaders must sooner or later consume their earnings and thus pay the tax. However, the conundrum is that if tax-evaders are low-skill workers, they may not generate the cash flow in the form of consumption taxes expected by the reformers.

This does not mean that there is no space for public action to reduce inequality, only that there is an increasing marginal cost to do so in a country with strongly defined...
skill groups, which leads the tax-collection system towards the deliberate separation of the population.\textsuperscript{6} Also, this creates room for long-term policies to improve the skills of disadvantaged workers, raise administrative efficiency of the tax system, and improve the quality of public services that are associated with the payment of contributions to social security.

4. Increasing taxes to widen the welfare state

Let us assume there is a goal of growing the relative size of the welfare state. If increasing government expenditures is bound to create a wedge in the labor market and a subsequent increase in efficiency cost, discouraging low-skilled workers from providing optimal efforts, perhaps an option is to look at improving social protection in a decentralized way.

The “Mexico collects too little money in taxes” dictum comes from comparing practices with France, Spain, Belgium and other European nations, the case weakens when the comparison is made with Korea, Chile, Japan, or even the United States, which operate relatively decentralized social protection systems. While a full development of the issue requires a detailed discussion of regulation, finance and provision of complex programs such as health care or disability insurance, we can review some information to see that countries with a more decentralized social policy have lower levels of taxation: Chile and the United States are perhaps the OECD countries with a social policy less based upon public national agencies, but Japan and Korea are also relatively decentralized.

Can or should or will Mexico move to a higher level of taxation with respect to GDP? This is a precondition for an expansion of the welfare state, in particular if centralized solutions are adopted (such as a National Health Plan). When and if higher tax collections are achieved, a second question relates to the structure of taxation; shall higher revenues be obtained through income, consumption or social security taxes?

On the level of taxation, Table 1 shows that in Latin America (LAC), only Brazil, Argentina, and Uruguay have collected more that Mexico in taxes during the last two decades. With respect to the OECD, Korea is the one comparable case of substantial increase in contributions; other OECD countries collect more that Mexico

\footnote{Perhaps “classes” is a term that can be used because personal characteristics that define membership cannot be changed; if those characteristics are transferred across generations, the term class more likely applies.}
recently but not proportionally more that in the nineties. On the issue of the structure of taxation, Brazil, Argentina, and Uruguay collect more that double in social security contributions compared whit Mexico. Overall, in the OECD social security collections are more than one quarter of total collections (Table 2). In both LAC and OECD there is a trend towards the use of general consumption taxation over special taxation. Yet, in LAC there in no trend towards lower overall consumption or social security taxation; there is a trend in the share of income taxation at the expanse of all other forms of taxation, although changes in structure are not large and may have been affected by the Great Recession (see Table 3).

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*Source: OCDE (2012b) and OECD/ECLAC/CIAT (2011)*
### Table 2

**Social security contributions, 1965-2008**

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Source: OECD (2010) and OECD/ECLAC/CIAT (2011)
5. Conclusions

To obtain resources to finance an equitable social subsidy program, a government has to collect taxes, and by doing so, it reduces the incentives to work. Taxes are obtained in a higher amount from those working longer hours with more productivity and, in the process the government does not wish to discourage these workers. Since the government does not know who is who in terms of skills to generate productivity, there is a risk that when mixing wage earnings and a social subsidy a more productive worker will prefer to mimic an unproductive one and thus save the work effort. To avoid this, the government induces the less productive to work less and so scrubs out this temptation for more productive workers.

How does this model compare with other analyses of informality? In the model of Arias, Azuara, Bernal, Heckman and Villarreal (2010), workers have different abilities, but the gap between formal and informal arises because prices to the consumer
are higher in the formal sector, which compensate firms with more payment of taxes for social security.

According to Levy (2008) but the presence of institutional and technological factors, as well as social programs determines the relative size of each sector. Among the institutional factors, workers own non-tradable investment goods and for low wage levels they prefer to work using those rather than working for a wage—this defines a formal labor market. Additionally, the relative distribution of the population across sectors depends upon an exogenous parameter of efficiency of social security in providing service, and also exogenous capacities of the state to collect taxes. If the demand for labor (i.e. wages) is high in the formal sector, the non-tradable capital of families loses relative value.

The model presented in this article can accommodate these arguments, although it emphasizes the classic problem exposed by Gertrude Himmelfarb (1992): societies do not accept that some of their members have an excessively low level of relative consumption, but the guarantee of consumption not only discourages the “deserving poor”; it may also affect the efforts of some “undeserving”. To work around this problem, the state regulates that in addition to being poor, the individual shall not exert too much effort to be eligible to a benefit.

Probably, disability programs provide us with the neatest expression of the above-mentioned conduct. This benefit is not granted to one who works because it is very difficult to separate two cases: the disabled making an extraordinary effort to work, from someone collecting benefits unduly and also working. We can notice that in the absence of a public objective of guaranteeing a benefit or of the asymmetry of information that prevents the government from knowing the real productivity of persons, we would obtain an efficient solution. Yet, the program offers the disabled a contract wherein he can receive a benefit as long as he does not work. Even when it would be socially efficient to see the disabled exert some work effort, the program prohibits it.

Social benefit programs—among which pensions and health are the largest—are archetypes of information structures subject to moral hazard. In that sense, we can extend the interpretation of our model because the problem of separating people of high- and low-skill or cost extends to more variables. For example, health insurance may have to separate people between a group authorized to purchase services additional to the basic benefit and a group for which additional purchases are prohibited, a
situation that may seem absurd to an external observer not considering the incentive constraint, but such will be the form in which the State precludes that individuals who can contribute simulate being “too ill” to avoid exerting effort.

Thus, the argument in this paper may apply to more than the relation between the State and the citizen in labor markets and social programs. For example, it seems that the government applies different standards of enforcement and steep schedules of taxation in the areas of safety and health, property taxes, taxes on vehicles, education and others. In these cases, one gets the feeling that the regulations and the tax-subsidy programs are designed to limit the advancement of those in the informal or low productivity sectors. “Informal” vehicles circulate freely in the roads, while the state enforces payment of taxes for “formal” vehicles and subsidizes gasoline for all. Cities are filled with land under irregular titles and defective public services, while the state enforces the holding of titles and taxation of other plots. In education, families face also an all-or-nothing choice of sending children to a private school for which they pay not only tuition but also taxes, or attending lower-quality subsidized public school.

On the specific issue of adding to tax revenues as a share of GDP, we can say that perhaps Mexico can increase tax collections if the structure moves towards higher social security contributions and long-term improvements in the administration of the VAT and the income tax can be sustained. Starting from the assumption that the federal government faces large pressures to grow the social protection system and if international comparisons are relevant, then gradual and sustained improvements in collections are feasible, but very large increases can come only if social security contributions increase.
References


Arias, Javier, Oliver Azuara, Pedro Bernal, James J. Heckman y Cajeme Villareal. “Policies to promote Growth and Economic Efficiency in Mexico.” IZA DP No. 4740 (Febrero 2010).


