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WORLD BANK GROUP
Social Protection & Jobs

Tax- and Benefit Reforms to make Formal Work Pay

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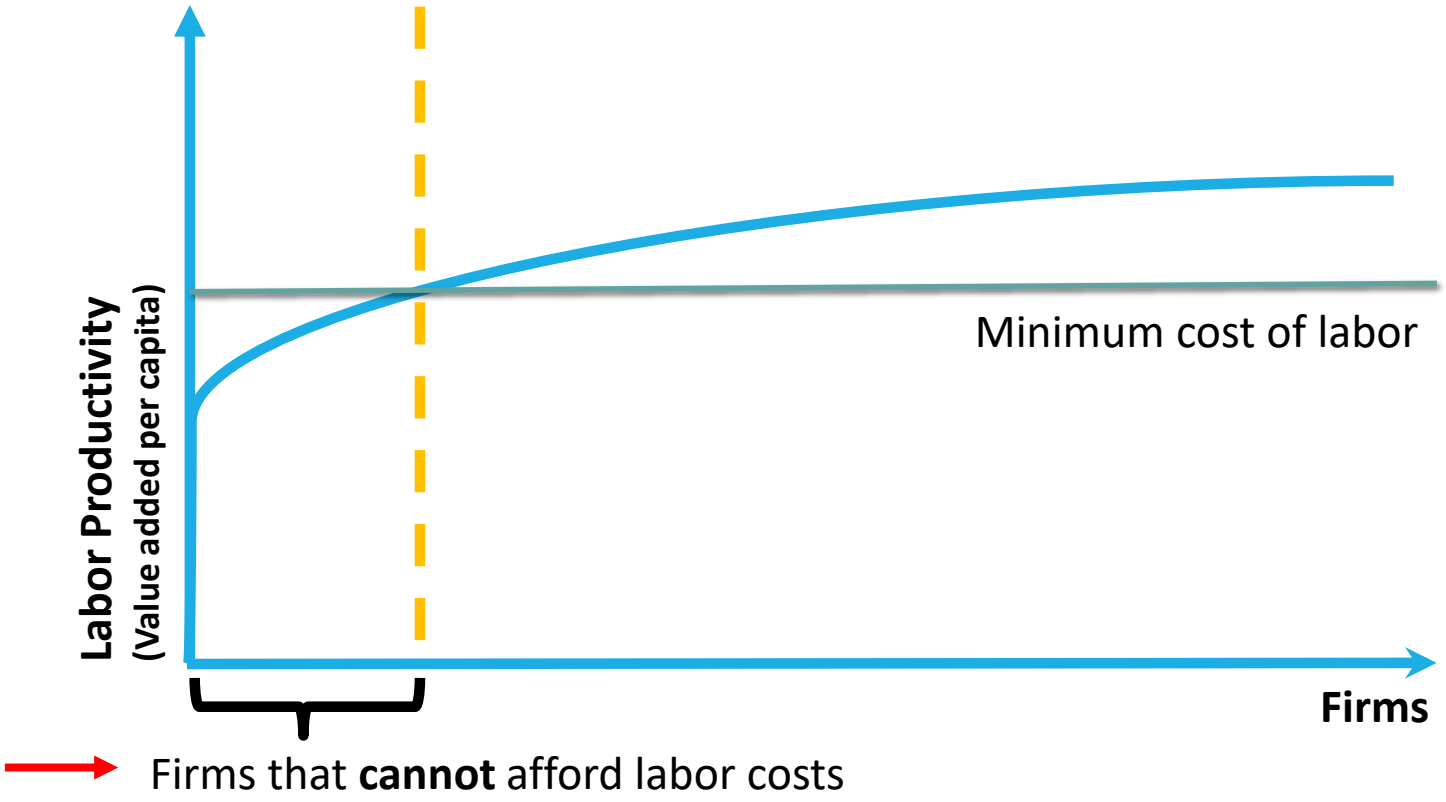
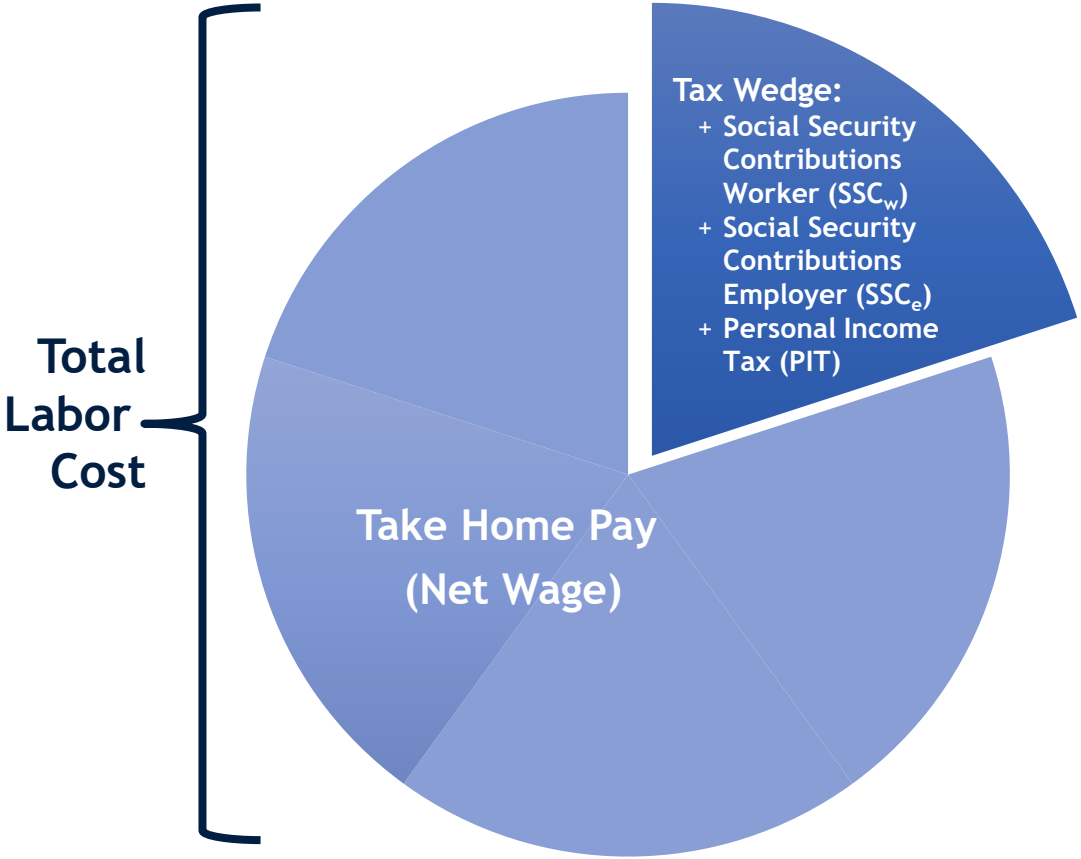
Jobs Diagnostic Course

Labor costs constrain low productivity, informal firms



$$\text{Tax Wedge} = \frac{\text{Personal Income Tax (PIT)} + \text{Social Security Contributions (SSC)}}{\text{Total Labor Cost (TLC)}}$$

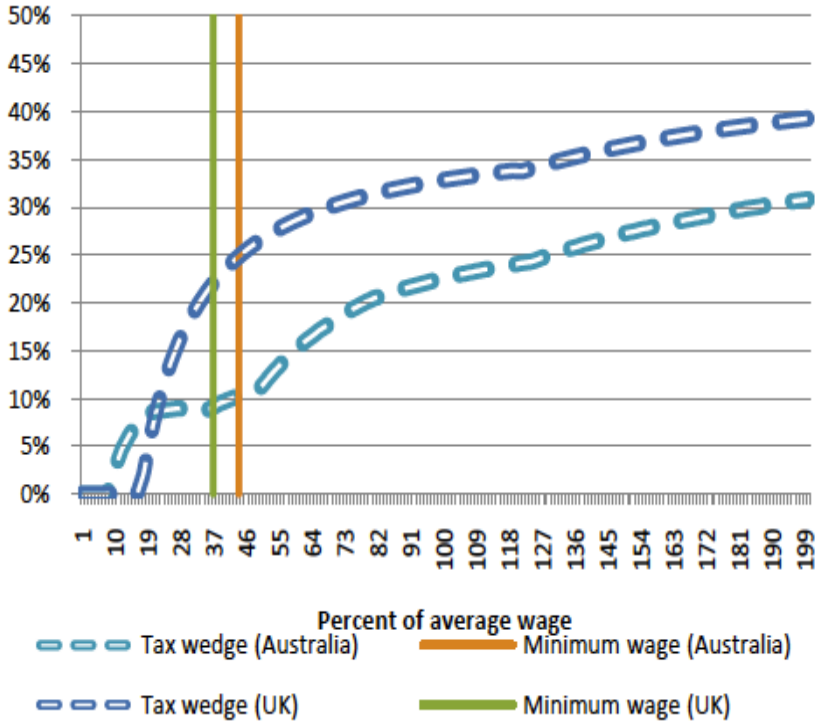


The **Tax Wedge:**

- ✓ measures the difference between total labor costs and take home pay
- \+ expresses the opportunity costs of formal work as taxes and social security contributions
- – does not capture the opportunity cost of informal work or inactivity
- – or the valuation of benefits
- ➢ Alternatives: METR, FTR, PTR

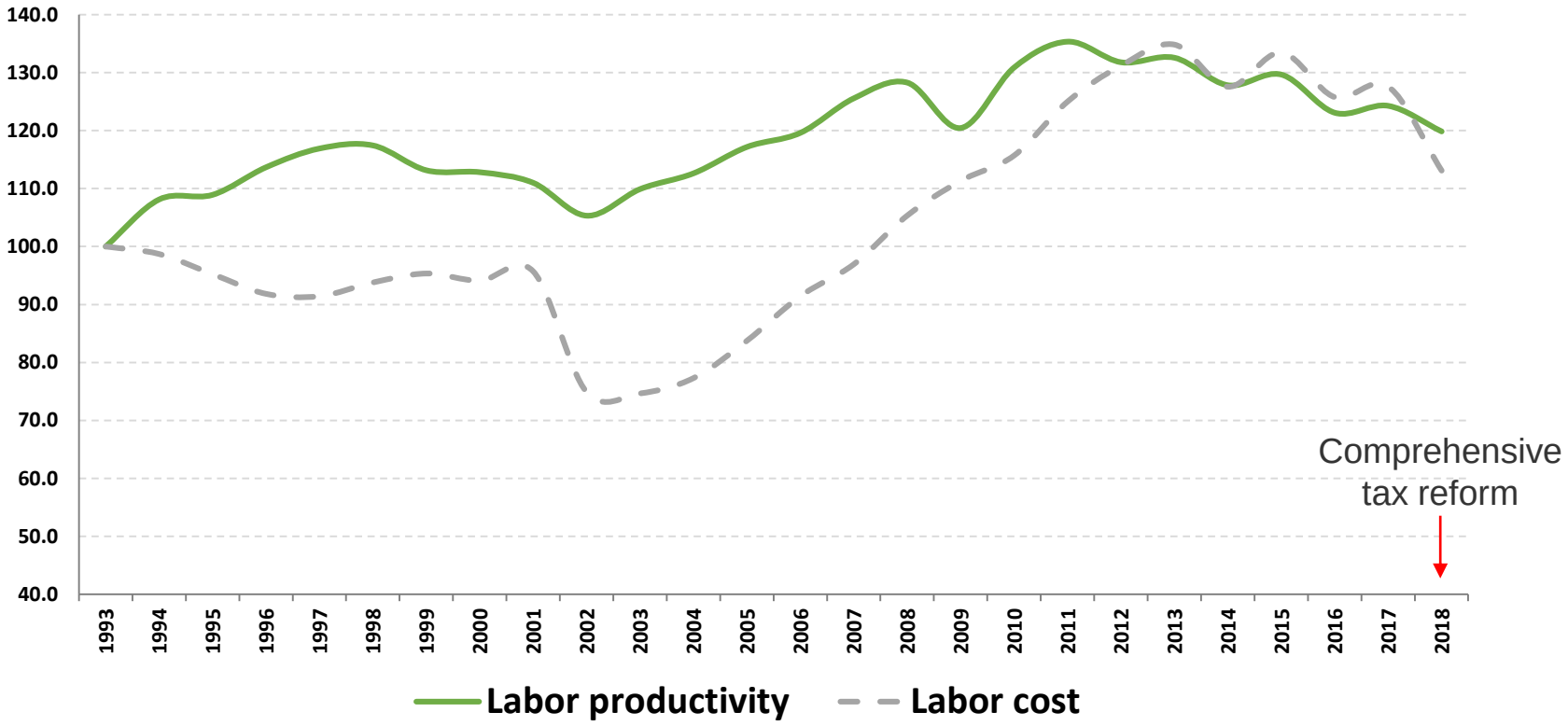
Tax wedge varies considerably within countries across wage levels

Tax wedge for single with no children across income levels for Estonia, Latvia, Australia, and the United Kingdom



Source: Koettl and Weber (2012)

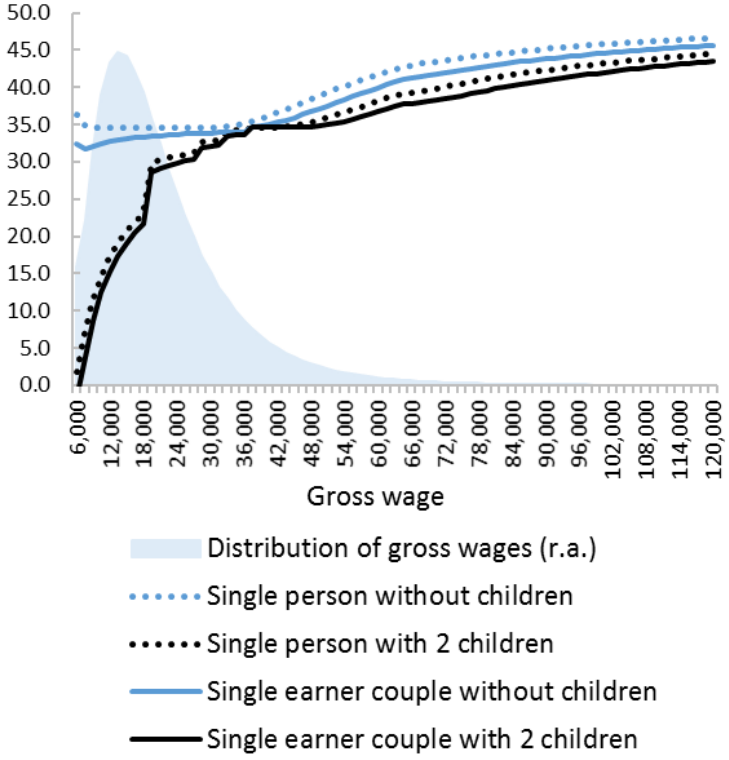
Example Argentina: Labor Productivity and Labor costs



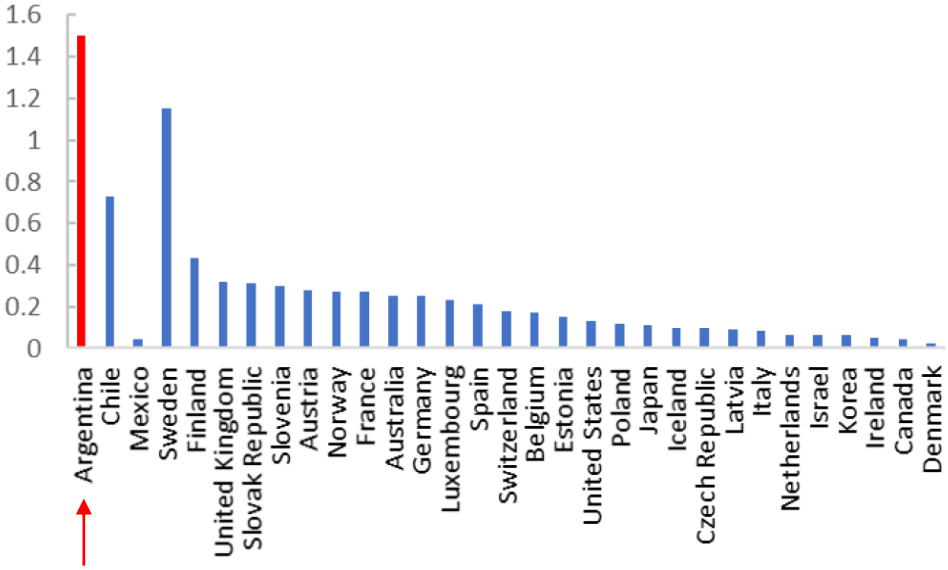
Source: G.A. Arakaki based on Kennedy, Pacífico and Sánchez (2016/2018)

Argentina's average tax wedge is the highest in Latin America

Tax wedge (percent of total cost to employer)



Ratio of minimum taxable income to average wage



Source: IMF Country report No. 17/410 (2017)

1. The Jobs Context

Labor taxation and social benefit designs can negatively affect pathways to better, formal wage jobs as they increase labor costs

Why care? → The relationship between labor costs and productivity:

High labor costs relative to labor productivity can reduce:

- employment (net job creation),
- working time,
- wages of employees, or
- profits.

Furthermore, it can lead to

- underreporting of formal wages (e.g. only minimum wage) or
- make workers/firms stay or become informal.

2. The Policy Failure

Misaligned labor tax and benefit systems create disincentives that "trap" workers:

- *informality trap,*
  when low productivity workers are stuck with informal firms that cannot afford to formalize
- *low-wage trap,*
  when large parts of the increases in earned income are taxed away through labor taxes, contributions, and reduced benefits, thus making work with higher (reported) earnings unattractive,
- *unemployment trap,*
  when social security or unemployment benefits reduce the motivation to quickly find a good match with an employer and take up a job (moral hazard), and
- *inactivity trap,*
  when the additional gross income would largely be taxed away if an inactive took a job (but is otherwise entitled to income-tested social assistance).

3. Jobs Constraints or Syndromes that identify the need for labor tax reforms

There is rising demand for goods and services, but...

- *… formal employment does not grow relative to the informal sector*
  (# workers with contracts or contributions to social insurance/health)
- *… wide gaps persist between formal vs. informal wages despite same occupations, skills, and other characteristics*
  (informal/formal wage probit regressions with controls)
- *… low-income or low-skill wage workers remain largely informal relative to others*
  (tabulations, decompositions, probits, and wage regressions)
- *… durations of unemployment stay comparatively high for those who receive benefits*
  (average durations in unemployment, transition rates over time)
- *… the share of inactive at working age remains high in certain households (despite low dependency or good education)*
  (share of inactive for different households controlling for individual and household characteristics)
- *… reported wages do not increase*
  (high share of minimum wage earners with little variation across sectors or occupations)

3. Fiscal Constraints or Syndromes that identify the need for labor tax reforms

Comparatively low fiscal revenues relative to contributions also point at issues:

- Measuring the effectiveness of collecting social insurance contributions:
  - ratio between the revenue yield (percentage of GDP) and the combined (employees + employers) social contributions (percentage)
  - affected by among others:
    - institutions and the design of social insurance contributions, such as income ceilings, and
    - the share of formal wage employment
- Examples
  - Revenue for <u>one percentage point of the combined social contribution rate:</u>
    - Cyprus, Israel, or Ireland: 1 pp. yields **0.50 percent and more of GDP**
    - In many developing countries: 1 pp. yields **0.10 percent of GDP or less**
  - Total revenue from social security contributions:
    - Slovenia: **14.8 percent of GDP**
    - Slovakia: **13.3 percent of GDP** but: contribution rate is **<u>eight</u>** percentage points **<u>higher</u> than in Slovenia**
    - Romania: **8.9 percent of GDP** but: contribution rate is **<u>six</u>** percentage points **<u>higher</u> than in Slovenia**
  - Wage employment rates (in percent of total employment, 2019):
    Cyprus, 86.8; Israel, 87.7; Ireland, 84.7; Slovenia, 85.6; Slovakia, 84.8; Romania,73.7

4. What works? Reform Options

1. Lowering or shifting the tax base away from labor
2. Modifying labor taxes and social security contributions
3. Incentives to include the self-employed and microenterprises
4. Strengthening enforcement and compliance
5. Raising awareness among the public on risks of tax evasion

4. What Works: Lowering or shifting labor taxes

→ Lowering and shifting the tax base from taxing labor to other sources of income (e.g. to consumption, property, or corporate income tax) – this could be neutral to revenue generation

- Example
  - Colombia:
    - Pre 2012: very high non-wage labor costs and informality
      - more than 60 percent of the average wage rate
      - high share of informal workers, depending on definition between 56 to 67 percent of the total workforce
    - 2012 reform:
      - reduced total payroll taxes on average by 22.4 percent (from 60.3 percent)
      - compensated by temporary increases in the corporate income tax and changes in the consumption tax

- Impact
  - Colombian reform
    - increased the number of formal jobs by between 3.1 and 3.4 percent
    - lowered informality by between 1.4 and 4.2 percent
    - increased gross wages by between 1.9 and 4.4 percent
    - highest impact among small and medium-sized enterprises
    - no estimates on substitution effect on goods & services affected by consumption tax

4. What Works: Modifying labor taxes and contributions

→ In-Work Tax credits for vulnerable groups - reduces taxes by increasing the tax refund

- Examples
  - USA: Earned Income Tax Credit (EITC)
  - UK: Working Families Tax Credit (WFTC)
  - Currently, at least 14 economies apply in-work tax credits (including Canada, France, Ireland, Korea, New Zealand, the Slovak Republic)

- Impact
  - improves transitions from unemployment to employment
  - shift the tax burden away from some disadvantaged groups (e.g. employed single-parents with low incomes)

4. What Works: Modifying labor taxes and contributions

→ Setting up a social contribution ceiling (on insurable earnings)

- Examples
  - Spain, Cyprus, Bulgaria: fixed amount (can be changed yearly)
  - Slovakia, Romania, Czech Republic: multiple of the average wage
  - Romania: minimum gross wage but only for sickness and maternity benefit contributions

- Impact
  - benefits higher income workers due to lower total contributions
  - increases likelihood of correct income reporting of higher incomes
  - enables selective limitations for specific social contribution schemes
  - raises acceptance of such social beneficiary categories
  - brings benefit ceilings in line with contribution ceilings

4. What Works: Modifying labor taxes and contributions

→ Reducing tax rates or contributions depending on taxable income or specific worker/household characteristics (e.g. age, disability, family structure)

- Examples:
  - Austria: no employee unemployment insurance contribution on incomes up to a specific limit
  - Slovakia:
    - contributions for the disabled are half that for regular workers
    - former long-term unemployed with low wages are exempt from unemployment insurance contributions
  - Germany: employer pays a reduced contribution for low-earners (on mini-jobs)
  - France: contribution for family allowances is paid by the employer at the rate of 5.25 percent, or 3.45 percent on wages lower than 1.6 times the minimum wage.
  - Australia, Denmark, the Netherlands, and Sweden: introduced specific tax credits for earnings of older workers

- Impact
  - a high labor tax wedge on low income earners is a major driver of structural unemployment (IMF 2014).
    - differences in the tax wedge explain about 30 percent of the variation in structural unemployment across countries,
    - a reduction in the tax wedge by 10 percent would reduce structural unemployment by 2-4 percent on average
  - Avoid spikes and ‘smoothen’ marginal tax rates (METR) for e.g. low income earners
  - Specific groups: reductions for e.g. older workers stimulate their labor market participation

4. What Works: Covering the self-employed

→ For the self-employed, countries establish minimum income criteria for social security coverage or provide discounts on the contributions

- Examples for coverage criteria
  - Bulgaria, Estonia, Slovenia: minimum wage
  - Latvia: minimum contribution threshold
  - Hungary: 30 percent of the minimum wage
  - Romania: three gross average monthly salaries in a year
  - Czech Republic and Slovak Republic: defined amounts

- Examples for reductions on contributions
  - Brazil: fixed monthly social security for self-employed (microempreendedor). Subject to maximum income threshold and allows up to one employee (at the minimum wage)
  - Argentina: reduced social security contributions for employers with a turnover of less than ARD 48 million or in selected industries
  - Poland: self-employed persons pay social security and health care contributions according to a lower basis for assessment.
  - Germany: self-employed individuals exempt from mandatory pension contributions

- Impact
  - Allows to formalize the income from self-employment
  - Cover the self-employed with social protection

4. What Works: Targeting small businesses

→ Discounts for small businesses

- Examples for small businesses
  - Brazil: single replacement tax to simplify tax compliance for SMEs (Simples) up to a gross revenue threshold. Microempreendedor are also exempt from federal taxes.
  - France: for general health insurance schemes, accidents at work, and occupational diseases → flat-rate deduction of employers' contributions of €1.50 per hour for businesses with less than 20 employees
  - Canada: credit for employment insurance premiums paid by small businesses (up to a specific amount)

- Impact
  - Allows to formalize the income of small businesses
  - Increases in the tax base

4. What Works: Strengthening enforcement and compliance

→ Increasing investments in enforcement and building better institutions while combatting corruption

- Enforcement options
  - Workplace inspection visits
  - Requirements for immediate declaration of businesses and employment relationships
  - Legal responsibility for the actions of subcontractors
  - Exchange of information and unique social security numbers
  - Whistleblowing systems – Reporting non-compliance, e.g. employers that cause unfair competition
  - Sanctions and amnesties
  - Presumptive taxation: administrative determination of assets or sales
- Examples
  - Greece, Zimbabwe: presumptive taxation - defining taxable income based on key factors associated with income generation, e.g. sales, turnover, number of employees, size of firm, or assets
- Impact
  - Expand revenue through broader tax base

4. What Works: Raising awareness for compliance

→ Campaigns and other interventions to raise the “moral cost” of evasion

- increase awareness among the public on the risks linked to non-payment of taxes and contributions, particularly also sanctions
- better public education and information to improve the willingness to pay taxes (‘tax morale’),
- shape perspectives of enterprises and individuals regarding the formal sector

- Examples
  - Hungary: “Fair Play” campaign in 2007 emphasized the damage that tax evasion does to the country’s financial situation.
  - Sweden: special campaign for young people at vocational schools and media campaigns about the risks of not participating in the social security system
  - Canada: focused on consumers of the construction sector highlighting the legal and financial disadvantages of illicit cash transactions and linking quality and professionalism with registered contractors

- Impact
  - Increased revenue collection,
  - firm registration, and
  - coverage with social protection schemes

5. Common Pitfalls

Mistakes to Avoid:

- Setting a tax floor but forgetting about low income/part time workers (e.g. Bulgaria)
- Higher taxes and contributions can lead to a larger informal sector
  - Increases the tax burden on registered labor and firms because of the narrower tax base.
  - Workers uninsured against health, old age, and other risks may have lower productivity and fewer incentives to invest in human capital accumulation.
- Ignoring distributional or marginal effects of changes in tax rates
  - The higher the marginal effective tax rate, the lower the incentives to look for work or to work additional hours.

Country Examples (With References)

Turkey, reduction in social contributions as part of the 2008 employment package:

- 5 percentage points reduction in pension contributions paid by employers
- 0.8 percent increase in employment overall
- reduced the unemployment rate by about 0.2–0.3 percentage points (Betcherman and Pagés, 2009)

Chile, reduction in labor taxes (1979-1986):

- average payroll tax rate reduction from 30 percent to 5 percent over a six-year period
- incidence of payroll taxation is fully on wages
- little impact on employment levels (Gruber, 1997)

Country Examples (With References)

Latin America, increases in labor taxation:

± a 10 percent increase in payroll taxes decreases employment by 4.5 percent in selected Latin American countries (Heckman and Pages, 2004)

Europe and Central Asia, changes of the tax-wedge:

Δ A one percentage point change in the tax wedge results in a 0.3-0.6 percent change in the employment rate (Rutkowski, 2007)

OECD, changes in the tax-wedge for 2017/2018:

+ 22 countries increased the tax wedge, while

− 14 countries decreased the tax wedge, esp.
  - Estonia (2.54 percentage points)
  - USA (2.19 percentage points),
  - Hungary (1.11 percentage points)
  - Belgium (1.09 percentage points).

For more information

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