

# Unemployment, informality and labor market performance

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Slides delivered at Foro Mundial de Empleo y Prosperidad,  
organized by Colsubsidio and Acoset in May 2012

1

## Outline

- Overview of Colombian jobs market
- Consequences of unemployment and informality
- Causes of unemployment and informality
- Non-wage costs and minimum wage laws
- Agency work
- Quality of employment

2

## Overview of Colombian jobs market

3

## Employment (2009)

- Male employment about 60% of working age population, female about 40%
- A bit less than southern Europe but base more wide, includes all ages 12+
- Close to 30% of population below poverty level that entitles to subsidized social services (SISBEN 1-2)

4

## Employment in industrial sectors

- Manufacturing 16%
- Construction 7%
- Services 77%

5

## Unemployment and informality

- About 12% unemployment rate
- Formal salaried 36%, informal salaried 25%
- Formal self-employed 2%, informal 36%

6

## Evaluation

- Employment levels low (esp. considering this is for cities only)
- Unemployment high despite apparently robust growth
- Informality high (even when measured by entitlement to health and pensions)
- Structure of employment: service economy

7

## Consequences of unemployment and informality

8

## Consequences of unemployment

- Unemployment bad for young workers
- Scarring effects: lower earnings and more incidence in future
- Disillusionment and crime
- Especially for long-term unemployed

9

## Consequences of informality

- “Unfair” in the sense that fiscal burden borne only by those who register
- Bad for incentives as taxes tend to be higher with substantial “involuntary” redistribution
- Creates vicious circle: informality forces higher taxes, which push more people into informality
- If not checked it could lead to unsustainable fiscal burdens

10

## More implications

- More volatile employment and incomes: bad for household planning and stability
- No incentive to observe ILO rules for standards at work
- No incentive to learn on the job and improve productivity

11

## Further implications

- Eventually creates a dual labor market, with the formal one dominated by the public sector and well-paid and organized jobs
- And the other by frequent entry and exit and lower wages
- Not good for competitiveness and flexible response to macro shocks

12

## Causes of informality and unemployment

13

### By choice or forced?

- Question whether workers forced into informality by absence of formal jobs, or choose to go is irrelevant
- In the case of “forced” it is a choice of the employer to create informal jobs
- Either way, someone chooses not to obey formal rules of engagement

14

## Why informality?

- Informality usually caused by high taxes on labor or regulation
- In Europe southern countries have high informality caused by regulation
- But Colombia's informal sector is bigger – especially surprising how big it is for salaried employees

15

## Why so much informality?

- Two causes appear to be critical
- The minimum wage is too high – employers go informal to avoid it
- The non-wage labor costs – essentially taxes on labor – are too high
- Both salaried and especially self-employed people go informal to avoid them

16

## What about benefits of formal employment?

- Other countries have high taxes but avoid informality
- Reason is that there are many benefits associated with holding a job
- In Colombia basic welfare benefits, such as health, given unconditionally to low-income groups

17

## Is that critical reason?

- Is subsidized health the real reason for the informality?
- No because other countries do it (e.g., UK) but have very low informality
- Subsidized health is an enabling factor – given other incentives to go informal, health provision is not an incentive to avoid it

18

## Non-wage costs and minimum wage laws

19

## Economics of non-wage costs I

- Non-wage costs in Colombia are very high by conventional standards, up to 60% or more for lower incomes
- Coupled with the minimum wage this makes (formal) labor too expensive
- Non-wage costs are necessary to finance welfare payments: pensions, unemployment compensation, other benefits

20

## Economics of non-wage costs II

- Beyond that, payroll taxes should not be used to collect general tax revenue; consumption taxes (VAT) are better
- Non-wage costs have no impact on employment when
  - The benefits from them are perceived and linked to the tax
  - They are not on low-wage workers

21

## Benefits and costs

- Do workers perceive the link between cost and benefit?
- In the case of pension there should be close link
- Difficult to link other benefits because there is need for redistribution – unemployment benefits, housing, etc., used by low-income groups but more taxes paid by high-income groups

22

## How to increase incentives

- Disincentives of non-wage costs strong at low wages
- Non-wage costs should be made progressive
- Wages close to minimum wage should pay no non-wage costs
- At higher wages disincentives much less
- For high-wage groups policing of reporting should be the solution to informality

23

## Economics of minimum wage I

- Minimum wage controversial in any context
- Can do a lot of good if selected carefully but can do a lot of harm if it is too high
- Minimum wage is beneficial if low-wage workers are employed by monopolies
- Monopolies push the wage below the worker's productivity

24

## Economics of minimum wage II

- Minimum wage law that pushes the wage up to labor productivity beneficial: increases the incentive that the worker has to work and has no effect on employment
- But if wage pushed above productivity it harms the workers as a whole: it benefits those that get the jobs but causes unemployment
- Overall workers are worse off

25

## What is the right level?

- Difficult to say what is the right level because we cannot measure productivity accurately
- Need experimentation: in the US, Card and Krueger found that the minimum wage helped employment in fast food outlets: clearly below productivity
- In UK, minimum wage had big impact on low pay but did not cause unemployment

26

## Levels and impacts

- In UK, minimum wage is 50% of median, or a bit less
- Lower wage for young workers (below 22) and even lower for very young (16-17)
- In Colombia, rates up to 80-90% reported in literature

27

## Impact of high minimum wage

- Firms cannot afford to employ many low-skill workers
- They either close jobs down or go informal
- Formal sector suffers from large jobs shortage
- Informal does not make up the shortfall

28

## Outcomes

- Outcome is low employment and high unemployment of low skill workers
- This explains why a fast growing country has high unemployment
- Because of low employment, more demand for social services
- Those in jobs taxed more to pay – hence non-wage costs go up, causing more jobs shortage

29

## Poor performance

- A single poor policy – too high a minimum wage – could be underlying poor performance on a number of dimensions
  - High unemployment
  - Large informal sector
  - High non-wage costs (taxes) on formal labor
- Only beneficiaries are the high-income workers in secure jobs, such as the public sector

30

## What to do?

- Reform urgently needed if country is to take advantage of its skills and the liberalization of the business environment
- Consider splitting the minimum wage between young and older workers
- Maybe also by education level

31

## The adjustment period

- Given political constraints, adjust to more reasonable levels gradually
- Allow only increases in minimum wage that match **past** inflation, not productivity, until productivity rise catches up with it
- Real incomes are protected and ratio of minimum to median drifts down to less harmful levels

32

## Help with employment

- Minimum wage may take long to adjust, even if policy followed immediately
- In the meantime, low-wage employment can be helped with wage subsidies by government
- Firms that hire unemployed could get wage subsidy for a limited period

33

## Summary of policy reform to benefit employment outcomes

- Reform minimum wage as just indicated – maintain real level whilst adjusting ratio to median
- Consider subsidizing firms that offer jobs to unemployed until minimum wage adjusts
- Reduce payroll taxes overall and shift burden to consumption taxes
- Reduce taxes and contributions by workers on low incomes and by SMEs

34

## Agency work

35

## Modern labor markets

- Modern labor markets are complex
- Too many different worker types, too many different job requirements: we summarize by term “frictions” problems caused by imperfect information and mobility costs
- Theory of matching developed as framework to study process that brings together firms and workers and process that separates them (job creation and job destruction)

36

## Job creation and recruitment

- Because of the frictions, employers spend resources on hiring activities
- Mainly advertising for candidates, screening and training/supervising after recruitment
- These are a small fraction of overall costs but they play an important role in the efficient performance of the firm

37

## Tenure patterns

- Successful recruitment leads to promotion and higher pay
- Employers unlikely to want to extend full rights of regular employee before they can be sure that job match is good
- Once both employer and worker satisfied that they have a good match, job could last for very long time
- Tenures have “long tail”

38

## Who does the hiring?

- Some firms may decide to do their own screening and hiring
- With the increasing complexity of the job structure in modern economies and the increasing job specialisation, this often requires special skills, provided, e.g., by specialists in HR departments
- Given how many jobs end after a short tenure, HR also acts as mentor for new recruits, helping to ensure that the match between employer and employee lasts

39

## Agency hiring I

- Agencies take on the task of screening and initial mentoring of employees
- As specialists, they may provide better service
- What makes agencies specialise in the markets that they do?

40

## Agency hiring II

- Reasons where a firm may hire through an agency
  - Hire on trial: useful in countries where agency workers are not given regular employee rights for a while
  - Temporary increase in demand: hire intending to fire
  - Temporary absence of regular employees: as above

41

## Advantages of agency hiring

- Agency hiring has the advantage that the company cuts down on the hiring costs. Someone else does the screening
- It avoids the burdens of frequent firing of workers
- From the employee's point of view, the advantage is that the worker is not "fired." The agency acts as regular employer

42

## More on advantages

- So there is less worker uncertainty about job prospects
- More regularity in the operations of the firm
- The firm could even hire the same worker, who works somewhere else when not needed
- But many workers use contingent work as a step to regular job (more than 50% on average)

43

## Advantages of “try before you buy”

- In the case of hiring on trial employer and employee get to learn about each other
- Learning is a natural response to “markets with information frictions”
- Especially useful in cases where there is more uncertainty about job type and/or worker type, e.g., marginal workers, unemployed etc.

44

## Optimal levels

- Is there too much of too little contingent work?
- We can only speculate
- Efficient levels of agency work depend on efficiency in processing applications for short-tenure jobs.
- Normally, firms do not pass much information about candidates to each other
- Agency acts as information pool

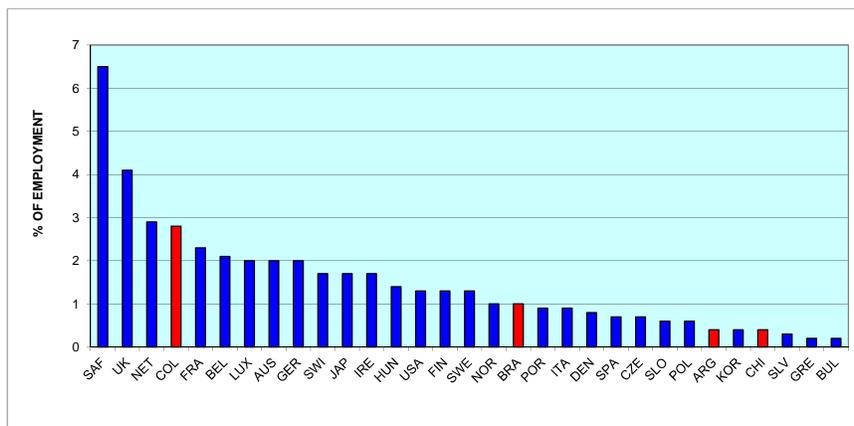
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## Why the differences in market penetration?

- Although contingent work has risen a lot recently, there are still many differences across countries
- In Europe, FTE workers range from just over 4% in Britain to 0.2% in Greece and Bulgaria
- Outside Europe South Africa is leader with 6.5% penetration followed by Colombia with 2.8%

46

## Per cent of FTE employment taken by agency workers



47

## Factors influencing penetration

- There are conflicting influences on the extent of penetration
- Companies in highly regulated labour markets would like agency workers, but difficult for agencies to operate
- In non-regulated markets, agencies find it easier to operate but demand by companies not as strong
- No clear patterns emerge except that agency work is on the ascendancy everywhere

48

## Trends

- Average for Europe increasing from 1.1% to 1.7% in 10 years 1998-2008
- As economy becomes more complex and more volatile, demand for short-term employment will increase
- Outsourcing of business services rising fast across the spectrum
- Scope to increase role of agency work

49

## Advantages to functioning of labor market

- Agency work facilitates transitions in the labor market by reducing recruitment time and costs
- It therefore contributes to reducing unemployment through lower duration of unemployment
- And by serving as a stepping-stone into the labour market

50

## Agency work and informality

- CIETT claims that the higher the agency work penetration rate the lower the level of undeclared work
- But this is based on a comparison of northern with southern Europe only: penetration lower in the south where informality is more common

51

## Quality of employment

52

## Modern labour market policy

- In modern labour markets governments take on the role of providing good quality social services to support workers
- European Union emphasizes “good jobs” when it talks about employment objectives
- Working people spend the majority of their time in the labour market and their productivity depends partly on the living conditions associated with the job

53

## A good example

- A good example of a policy that has had success is “flexicurity”, pioneered by Denmark
- Firms given a lot of flexibility in their employment choices
- Government takes on the role of supporting workers with good social services

54

## Financing

- The social services are financed by taxing the jobs
- Because the revenue is used to support employment, the policy is not a net disincentive to job creation
- The tax may have negative impact if viewed in isolation but the use of the revenue has positive impact and offsets it

55

## Colombia's Colsubsidio and others

- One can view companies like Colsubsidio as playing the role of government in the provision of services
- They collect a 4% “tax” from employers and provide social services that improve the quality of life of the employee

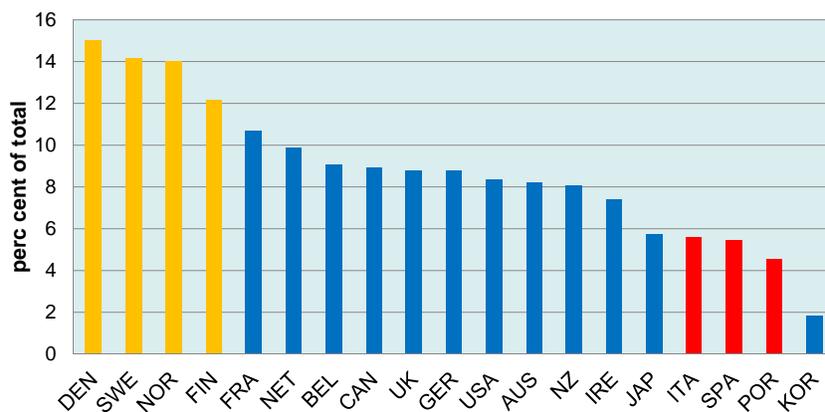
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## “Social” services

- In OECD countries the services provided (housing assistance, child benefits, cash transfers to spend on basic needs, UI assistance etc.) are provided by the government
- Scandinavian countries are pioneers, southern Europe and Japan-Korea much less

57

## Example: Share of employment in health and social care



58

## Why subsidized social services?

- Considered to be essential in a modern society to avoid co-existence of economic well-being and poverty
- Also have an important economic role: incentives and ability to do well in work enhanced – compare with Japanese “lifetime” job where the company is providing the social service

59

## Who should provide them?

- Clearly, such services need to be provided by non-profit making organizations, in order to give incentives to improve quality of services rather than maximize profit
- Is a government department, or a government agency, better at providing such services than a private company?
- Not necessarily, provided there are mechanisms for evaluating the performance of the private company (and government!)

60

## History and institutions

- Different countries develop different institutional structures by historical accident or other reasons
- Once they work well no need to change them – “one size fits all” is not a good policy objective in labor markets
- Important point to note is that improving the quality of life of low-income workers with subsidized social services or social transfers is good for social cohesion and productivity growth

61

## Monitoring and evaluation

- Institutions need to be monitored and their performance evaluated
- In Colombia’s case a big advantage of current practice is that there is a clear connection between the tax paid (the 4%) and the cost of the services
- Many European countries abuse the system and use social contributions to finance the general budget and show less overall debt, to the detriment of the quality of social services

62

## Conclude with reminder of ground covered

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- Causes of unemployment and informality
- Non-wage costs and minimum wage laws
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