Introduction

Three features of Mexico's development over the period from 1997 to 2006 stand out. One, per capita GDP and productivity growth was slow by international standards, despite the fact that Mexico experienced a decade of macroeconomic stability and implemented some reforms to increase efficiency.[1] Two, growth in formal employment was equally slow.[2] And three, there was a large expansion of health, housing, day care, and pension programs for households lacking social security coverage.[3]

The first two features generally are not associated with the third, at least not in the sense of there being a causal relationship between the increase in social programs for workers in the informal sector and diminished growth in GDP, productivity, and formal employment. If anything, the greater opportunities associated with

1. Average annual GDP growth was 3.4 percent and per capita growth 2.2 percent from 1997 to 2006. In the same period, output per worker grew at an average rate of 1.3 percent (see table 5-3 in chapter 5 and table 8-3 in chapter 8).

2. From 1997 to 2006, workers registered with the Instituto Mexicano del Seguro Social (IMSS) (Mexican Institute of Social Security), the social security institute for non–public sector workers, increased at an average rate of 3 percent. As a result, the share of workers registered with IMSS in the total labor force increased only from 28.4 to 31.6 percent. At that rate it would take approximately five more decades to achieve universal coverage (see table 8-3).

3. Resources for such programs were expected to increase by 110 percent in real terms from 1998 to 2007 (see table 1-5).

expanded social programs are assumed to contribute to economic growth by helping to improve the health and education of the labor force and, more generally, to improve the political environment in which policies are made by reducing inequality. The reduction of inequality is assumed to result from expanded social spending.

Many would attribute Mexico's lackluster growth in formal employment and productivity not to the increase in social programs for informal workers but to other factors, such as the high cost and uncertain supply of energy associated with public monopolies in the energy sector; the high cost of telecommunications, derived in turn from the monopolistic features of the telecom industry; generally infrequent lending to firms because of the uncertainty of property rights and the oligopolistic behavior of private banks; rigidities in the labor market derived from costly and cumbersome regulations; deficient education, associated in turn with the monopolistic position of the union of public school teachers; and an abnormally low tax base, resulting in insufficient public investment in growth-promoting infrastructure.

Those are substantive factors that would reduce the growth rate of any economy, even more if they occurred in some combination or if all of them existed at the same time. My objective here is not to argue the merits of each or to weigh their relative importance. It is to argue that there is yet another factor that contributes to low growth in GDP, formal employment, and productivity in Mexico: an incoherent social policy that gives workers incentives to seek low-productivity jobs and firms incentives to invest in privately profitable but socially suboptimal projects. More generally, *I argue that the incentive structure implicit in social programs leads workers and firms to behave in ways that are contrary to enhancing long-term productivity growth.*

Economic development usually is associated with a process whereby workers gradually shift from low- to high-productivity activities because of changes in the composition of output (generally reduced employment in agriculture and increased employment in manufacturing and services) or because of the adoption of more capital- or technology-intensive production processes. Either way, the result is an increase in labor productivity, which is the basis for an increase in real wages. The arguments made here, if correct, imply that *social policy in Mexico acts as a drag on that process* because it slows down the reduction of low-productivity agricultural employment; subsidizes inefficient self-employment and other forms of nonsalaried employment as well as illegal salaried employment; and interferes on one hand with the process by which workers seek more productive jobs and on the other hand with the way firms invest, grow, adopt new technologies, train workers, and, more generally, take measures to increase productivity.

I must state at the outset that I am not arguing against social programs. On the contrary, I believe that they are an indispensable part of any government effort to protect households from various risks, increase equality of opportunity, and combat poverty—especially so in Mexico, given the country's deep inequalities. My argument is different. It is, first, that the specific mechanisms by which social programs operate de facto generate incentives for workers to seek employment and firms to invest in low-productivity activities; second, that those mechanisms are an obstacle to achieving the very objectives of the programs; and third, that the sources of funds used to pay for the programs imply that the programs have a weak redistributive impact. The point therefore is not to eliminate social programs but to improve them; it is a question of means, not ends.

For the purposes of this book I define social policy as the set of programs through which the government offers health services, housing loans, day care services, and various types of pensions to workers of any income level, type of employment, or labor status. Those programs take the form of *social security* when they deal with workers in the formal sector, in which case they also include firing and severance pay regulations;[4] they take the form of *social protection* when dealing with workers in the informal sector. I exclude from social policy any policies dealing with education and other policies to increase households' welfare, such as infrastructure projects to improve the supply and quality of potable water and measures to protect households from natural disasters, terms-of-trade shocks, and the like.

I emphasize here that social protection programs are *not* equivalent to poverty reduction programs; they are programs that provide benefits to all workers who are not covered by social security, regardless of their income level. The common denominator of the social security and social protection programs considered here is that they bear on the labor market and, as detailed below, are contingent on the employment status—formal or informal—of workers.

In this volume, my first aim is to analyze the effects on workers and firms of the incentives offered by social security and social protection programs. The analysis focuses on two dimensions: one, a *social dimension,* by asking to what extent the two programs in combination protect workers from various risks and redistribute income in their favor; two, an *economic dimension,* by determining the effects of this combination of programs on workers' and firms' behavior along various dimensions that affect productivity growth. My second aim is to convince the reader that *Mexico's current combination of social programs is detrimental in both social and economic terms.*

This is not a monograph on poverty. Nevertheless, the framework developed here extends to consider the impact of social programs on poor workers; as a result, the analysis focuses on workers in general and poor workers in particular. In that context I pay special attention to the Progresa-Oportunidades program, which, because it targets households on the basis of income level, is a poverty reduction

4. Those regulations usually are catalogued under the rubric of labor policy, but their effect on the incentives of firms and workers is similar to that of the social programs analyzed here, so I treat them as analogous.

program, *not* a social protection program. My third aim is to analyze the incentive compatibility between the Progresa-Oportunidades program and the social security and social protection programs, which target workers on the basis of labor status, regardless of income level.

The focus on poor workers is important given the importance of poverty itself but also because I try to show that *the incentives of social protection and social security programs in Mexico are especially detrimental to poor workers* and may offset the positive effects of a direct income transfer program like Progresa-Oportunidades.[5] I argue in particular that under current conditions, poor youth who enter the labor force in the coming years after having benefited from Progresa-Oportunidades will be very unlikely to find jobs in the formal sector, which offer social security coverage, and that few firms will be willing to invest in training them and gradually raising their productivity. Those youngsters, while healthier and more educated than their elder peers, will end up in low-productivity jobs in the informal sector. Under current conditions, Progresa-Oportunidades is unlikely to break the intergenerational transmission of poverty, even if the program continues to deliver its benefits to poor households. That will not be because of the program itself but because the incentives to poor workers and the firms that hire them generated by the interplay of social security and social protection programs in the labor market are not aligned in the direction of raising productivity and increasing real wages. The human capital of poor workers may be raised by Progresa-Oportunidades, but their productivity in the labor market will not increase.

It is my view that much of the attention given to formality and informality in employment—certainly in Mexico and probably in Latin America in general—has focused on barriers to entry in formal employment, on one hand, and on the inequities created by the lack of social benefits for informal workers, on the other. My fourth aim is to argue that those views are flawed. I show that even with full mobility of workers, the labor market is segmented and that in fact that segmentation is *caused* by social programs. My view of informality differs from other views in two substantive aspects. First, I provide evidence indicating that workers in the informal sector are not unprotected from risks. Second, I argue that the relevant segmentation caused by the formal-informal dichotomy is in the productivity of workers across sectors, not in their standard of living. More pointedly, *I argue that by lowering productivity, informality hurts both formal and informal workers and also lowers the productivity of capital, with negative implications for GDP growth. I also argue that informality will persist; it will not fade away automatically as a result of economic growth.*

5. The ratio of poor households to total households increased from 23 to 37 percent as a result of the 1994–95 peso crisis and then fell steadily to 18 percent by 2004 (World Bank, 2005a, vol. 2, p. 153). Evidence shows that the income transfers from Progresa-Oportunidades have contributed to that reduction; see Levy (2006a, chap. 3).

My fifth and final aim is to explore policy alternatives. To do that, I discuss in a simple but I hope useful way the budgetary constraints under which social policy is carried out in Mexico. I try to separate two aspects of the government's social goals that are at times confused: those associated with protecting workers from risk, on one hand, and those associated with redistributing income, on the other. Having shown (I hope!) that at present both aims have been only very partially achieved, that labor and capital productivity have been lowered by the government's social policies, and that poor workers have been the ones who have lost the most from the current policy stance, I sketch the basic profile of an alternative policy—one that is better in social and economic terms in general and better for poverty reduction in particular.

My core proposal is to redefine social security—in terms of both its scope and the way in which it is financed—and to provide universal social entitlements to all Mexican workers, financed out of consumption taxes. The negative income effects of increased consumption taxes on poor and low-wage workers would be offset through direct income transfers. This proposal is feasible, it can be gradually implemented over the course of the next several years, it is fiscally sound, it suits the needs of Mexico's workers better than current policies, it is more effective at redistributing income toward low-wage workers, and it will make GDP grow faster. But it can be carried out only if the strategic interactions between social and economic policy are recognized and fully integrated into policy design. Policymakers must cease to view informality and the illegalities associated with it as a transitory nuisance that will fade away as GDP grows; they also must abandon the notion that simply maximizing social spending subject to the fiscal constraint from a growing and increasingly disjointed set of programs contributes to Mexico's long-term development. The proposal made here requires changes in the way policies are thought of, discussed, and implemented in Mexico; it requires the explicit recognition that social programs have a large impact on the relative price of the single most important non-traded input, labor; and it requires a focus on the adoption of policies that promote legality, social cohesion, and productivity *at the same time.*

This core proposal is complemented by a plea for Progresa-Oportunidades to keep a sharp focus on its human capital formation objectives and for policymakers to resist the temptation to use the program to solve all poverty-related problems. To bring about more rapid, permanent poverty reduction in Mexico, Progresa-Oportunidades has to be complemented by a radical change in incentives in the nation's labor market. Providing continuous increases in income transfers to the poor cannot substitute for making that change.

In sum, in this book I argue that the design of social policy in Mexico is flawed and that many of the programs introduced over the last few years have aggravated the problem. I argue that if present policies persist, the country will continue to experience low productivity growth, large-scale violation of the laws meant to protect workers, and reduced international competitiveness. I argue that while preserving the country's hard-won macroeconomic stability, it is high time to address the substantive distortions that are limiting Mexico's growth and that social policy reform needs to be at the center of that effort. I argue that it is feasible to design a new social policy that is fiscally sustainable, that is more effective at reducing Mexico's income inequality and protecting workers against risks, and that contributes to higher productivity and faster growth. And I argue that a social policy with those characteristics is indispensable to Mexico's development strategy.

The analysis and discussion in this volume may be relevant to other countries that have a dual system of social provisioning in an economy characterized by both a formal and an informal sector, which is the case in many Latin American countries at least. Its relevance is greater if informality in those countries, as in Mexico, is a cause of low productivity and results in part from the incentive structure implicit in their social programs. Despite the best intentions, in some countries, social security and social protection programs are a source of social exclusion and segmentation. As a result, it may be as indispensable in those countries as it is in Mexico to drastically reform those programs to move toward social inclusion and universal social entitlements and at the same time toward increased productivity and faster growth. Such countries face a great challenge and an equally great opportunity, as does Mexico.

This analysis also may be relevant to policymaking in other countries that have income transfer programs like Progresa-Oportunidades, of which there currently are more than twenty. In my view, an insufficiently studied aspect of such programs relates to their eventual phase-out, in particular their interface with other social programs that affect opportunities and outcomes for the poor in the labor market. If that interface is not given the attention it requires, the medium-term objectives of the programs will be more difficult to reach. I argue that poverty policy, after raising current consumption and ensuring that poor workers do not enter the labor market at a disadvantage vis-à-vis other workers (which a program like Progresa-Oportunidades can do), needs to focus on the impediments faced by poor workers to obtaining formal sector jobs with prospects for increasing productivity (which a program like Progresa-Oportunidades cannot do).

Main Hypothesis

My central hypothesis consists of three parts. First, social policy takes the form of social security programs for salaried workers and social protection programs for nonsalaried workers, who consist of self-employed workers and workers having nonsalaried contractual relationships with firms. Differences in the nature of the benefits and in the financing of social security and social protection programs result in *a tax on salaried labor and a subsidy to nonsalaried labor.* The labor force is segmented into a formal sector, which has social security coverage, and an informal sector, which has social protection coverage. But because social security and social protection programs are not the same, workers of similar characteristics and abilities receive unequal social benefits—in one case being forced to purchase a bundled set of benefits and in the other being given the option to choose any of the benefits in an unbundled set or none of them. If the government's social objective is to provide similar benefits to similar workers, that objective is not being achieved. Further, if the government's social objective is to ensure that all workers have health insurance and save for retirement at the same time (or have any other joint set of benefits), the combination of social security and social protection programs leads the government further away from accomplishing that objective.

Second, the tax on salaried labor reduces salaried employment and the subsidy to nonsalaried labor increases nonsalaried employment. *Larger than optimal informal employment lowers aggregate labor productivity.* In addition, some firms hiring salaried workers evade social security laws, giving rise to illegal salaried employment in the informal sector. The labor costs of formal firms hiring salaried workers are higher than those of informal firms hiring nonsalaried workers and those of informal, illegal firms hiring salaried workers. The cost difference occurs because the supply of labor to the formal sector is reduced and because formal firms have to cover all the costs associated with the governance mechanisms that apply to salaried labor while other firms do not. In turn, differences in the cost of labor produce differences in the returns to capital across firms. Given the cost of credit, investment is distorted in favor of the informal sector, where the productivity of labor is lower and the additional GDP obtained from a given investment effort is less. In other words, the formal-informal dichotomy increases the economy's incremental capital-output ratio. *Distortions in the allocation of investment reduce the productivity of capital and cause dynamic productivity losses and a lower rate of growth in GDP.*

Third, because of differences in the quality and regional availability of health care facilities and other infrastructure to deliver social security and social protection benefits, poor workers value social security benefits less and social protection benefits more than other workers do. On one hand, poor workers self-select into the informal sector; on the other, because there are larger rents to share between firms and poor workers when social security is evaded than between firms and non-poor workers, evasion is more common with poor workers.

The net effect of social programs is that poor workers account for a disproportionate share of informal employment. Whether they are hired as salaried workers by illegal informal firms, are employeed by legal firms in nonsalaried positions, or are self-employed, their productivity is lower than it could be if they were employed in the formal sector. Aside from being less productive, poor workers receive benefits through various unbundled social protection programs, not through a bundled social security program; that implies that they may or may not save for retirement, save for a house, or have health insurance. *Social policy therefore fails where it is needed most and, despite Progresa-Oportunidades, contributes to trapping the poor in poverty.*

I present two subsidiary hypotheses, not necessary to the main argument but relevant for Mexico. Because there is large-scale mobility of workers in Mexico's labor market, the incidence of wage-based social security contributions falls mostly on workers, formal and informal. In fact, given labor mobility, those adjectives are misleading. Rather than just formal and informal workers, in Mexico there are workers who work part-time in the formal and part-time in the informal sector. In that context, the potential redistribution of income that can occur through social security and social protection programs is limited to the share of the programs' costs paid with government subsidies. But the extent to which that potential redistribution is realized depends in turn on the nature of the fiscal adjustments made to pay for the subsidies. In other words, even if social security and social protection programs are subsidized, income is not necessarily being redistributed from high-income to low-income households.

The first subsidiary hypothesis is that in the 1997–2006 period, an important share of the subsidies to social security and social protection programs has been paid for with oil rents and not with additional taxes on higher-income households, limiting the effectiveness of the programs in reducing Mexico's income inequality. The second subsidiary hypothesis is that another share of subsidies to the programs has been paid for by reducing public investment in infrastructure, contributing to lower GDP growth.

The central hypothesis is consistent with the literature that points to microeconomic distortions in factor markets as an important determinant of aggregate productivity growth.[6] The novelty here lies in three areas: first, in identifying social programs as another source of microeconomic distortion; second, in showing that *these programs can segment the labor market into a formal and an informal sector even when there are no barriers to workers' mobility, such as binding minimum wages or others;* and third, in pointing out that the illegal nature of some informal economic activity affects productivity growth. Informality is not innocuous.

This volume hopes to contribute to answering four questions: one, how can social programs affect productivity and growth? Two, why do firms producing very similar or identical products do so at very different levels of productivity? Three, when wages are fully flexible, why do similar workers have different levels of productivity and different social benefits? And four, why is informal employment concentrated among poor workers? Those questions, aside from being interesting in their own right, are important for development policy in Mexico for two simple

6. See, for example, Banerjee and Duflo (2004) for an analytical discussion and Hsieh and Klenow (2006) for some empirical measurements.

but powerful reasons: *the majority of firms and workers are informal, and almost one of every four workers is poor.*

Organization

This book has ten chapters, divided conceptually in three parts. The first part deals with the *setting* of the problem and consists of five chapters. Chapter 1 describes Mexico's social security and social protection programs and presents data on the budgetary resources channeled to each over the 1998–2007 period. Chapter 2 introduces the concepts of formality and informality and discusses the differences between previous treatments of informality and the one proposed here. Chapter 3 discusses the factors affecting workers' valuation of the benefits of social programs in Mexico. Chapter 4 provides information on patterns of land ownership and labor market participation among poor workers and explains why their valuation of social programs differs from that of non-poor workers. Chapter 5 presents stylized facts on the labor market, provides evidence on worker mobility, and discusses the implications of mobility for social policy.

The second part, which consists of three chapters, deals with the *behavior* of the main actors. Chapter 6 develops a framework to identify how workers and firms react to the incentives implicit in social policy, which determine the productivity of labor and the composition of employment, which in turn determine the coverage of social security and social protection programs. The chapter also focuses on the static efficiency costs of those programs. Chapter 7 focuses on the illegal dimensions of informality, analyzing why there is illegal salaried labor in Mexico and how the behavior of illegal firms—those hiring salaried workers without social security coverage—affects the size distribution of firms and the composition of output. Chapter 8 assesses how informality affects the composition of investment and explores other dimensions of firms' behavior that affect the productivity of capital and the rate of growth of GDP. It also discusses the incentive compatibility between the social security and social protection programs, on one hand, and between those programs and Progresa-Oportunidades, on the other.

The third part of the book, which consists of two chapters, deals with *policy*. Chapter 9 discusses the fiscal implications of social policy and elaborates on the centrality of the fiscal constraint in determining the current combination of policies; it also discusses the extent to which social programs in Mexico serve to redistribute income toward workers. Chapter 10 presents a fiscally and administratively feasible proposal to reach the government's social objectives more effectively with all workers while increasing productivity and GDP growth.

Given the scope and complexity of the issues involved, I try to find a middle ground between a general discussion and a detailed analysis of each issue. The risk of the former is that I will fail to convince more academically minded readers that the propositions made have some merit; the risk of the latter is that more policy-minded readers might find the paper too technical or far removed to be of practical value. Each of the issues discussed deserves a more detailed analytical and empirical exploration than the one presented here.

My methodological approach is eclectic. I avoid mathematical arguments, relying instead on graphs, which I hope make it possible for the nontechnical reader to follow the main points. Various appendices elaborate on the technical aspects of some arguments. I also try to present empirical examples of the various propositions to convey a sense of the order of magnitude of the points made in the text. In chapter 5, I do present a more systematic empirical and econometric analysis of wage rates and worker mobility in the labor market, which plays an important role in the overall argument. However, this volume does not present a rigorous mathematical or econometric analysis, nor is its emphasis on the technical complexities of such an analysis.

My approach is based on the belief that there is much to be gained by taking a broad view of the issues and, further, that only if policymakers have an understanding of the *interactions* between different social programs can sensible reforms be carried out. An analysis of the details of individual social programs is necessary but not sufficient for understanding the net effects of social policy. That requires considering how the various pieces of the puzzle fit together rather than only a careful analysis of each piece in isolation. But focusing on the interactions among the social programs in Mexico as opposed to the detailed workings of a single program necessarily involves trade-offs, and the ones that I have made inevitably are biased by my own abilities and interests, tilted as they are in the direction of policy. If this volume has merit, it is in contributing to the elaboration of a framework for understanding and reforming social policy in Mexico *and in pointing out that such understanding and reform are crucial for economic policy.* I hope that the more academically minded readers find the discussion thought provoking, while the more policy-minded readers consider the analysis relevant to their tasks.