



Santiago Levy, Good Intentions, Bad Outcomes: Social Policy, Informality, and Economic Growth in Mexico

Author(s): Nora Lustig

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Santiago Levy. *Good Intentions, Bad Outcomes: Social Policy, Informality, and Economic Growth in Mexico*. Washington, DC: Brookings Institution, 2008. Pp. xv+357. \$27.95 (paper).

NORA LUSTIG

Tulane University

The opportunities to read a book by someone highly versed in economic theory and empirics with first-hand practical knowledge of government policies are not abundant. *Good Intentions, Bad Outcomes*, by Santiago Levy—who was director general of Mexico's Social Security Institute when many of the ideas meticulously researched in this book germinated—gives us such a treat. The book's main purpose is to demonstrate how Mexico's current mix of social security and social protection policies locks in horizontal inequities (similar workers receive different benefits), lowers aggregate labor productivity and growth, reduces government revenues, creates incentives for illegal activity, and does not help the poor—at least, as much as it could. The second purpose is to propose an alternative policy mix that would avoid these bad outcomes.

In the first five chapters, the author describes the characteristics of Mexico's social security and social protection systems (chap. 1), presents a razor-sharp definition of formality and informality (a welcome step, given the fuzziness with which the concept is treated in much of the existing literature) and compares differences in the treatment of this dichotomy found in the literature (chap. 2), discusses differences in workers' (and between poor workers and others) valuations of social programs (chaps. 3 and 4), and presents stylized facts of Mexico's labor market with a particular emphasis on mobility and its link to social policy (chap. 5). Using a partial equilibrium labor demand and supply framework, Levy estimates the efficiency costs associated with a sub-optimal allocation of labor between formal and informal sectors (chap. 6) and shows how one particular form of informality (illegal firms, i.e., those that hire salaried workers but do not pay the mandatory social security contributions) is particularly pernicious to productivity because of the effect that illegality has on the size distribution of firms and composition of output (chap. 7). Chapter 8 includes a mainly heuristic discussion of the potential negative impact of the oversized informal sector on investment and the productivity of capital and growth; in this chapter, Levy also argues that there is an incompatibility in the incentives generated by the conditional cash transfer program *Progresa/Oportunidades*, which encourages investment in schooling, and the incentives generated by the current social policy mix, which drives people into the informal/lower-productivity sector. The fiscal implications—including the

redistributive impact—of the current scheme are discussed in chapter 9. In chapter 10, Levy presents an alternative proposal that would deliver better outcomes in terms of the state's social objectives and growth.

The subset of social policies analyzed in this book are “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” (3).¹ The programs take the form of contributory social security, when they deal with workers in the formal sector (composed of 38% of the labor force in 2006; 87), and noncontributory social protection in the informal sector (58% of the labor force; 87). The main difference between the two is that, in the case of the formal sector, workers are forced to consume a bundled set of goods and services largely paid by payroll taxes (and a smaller portion by government subsidies), while, in the case of the informal sector, workers can choose which goods and services (of the offered menu of social protection) to consume, and their cost is financed out of general government revenues.

In sum, employment in the formal sector is taxed (because workers do not value the benefits in full), while employment in the informal sector is subsidized. With the expansion of noncontributory benefits that took place in Mexico in the last decade, the subsidy to informal employment has increased. Levy estimates that, on average, taxes to low-skilled formal workers amount to 25% of their wage, and subsidies to informal workers are equivalent to 8% of their remuneration. Poorer workers will tend to opt out of the formal sector because their valuation of formal social security benefits is lower—given, for example, the lower quantity and quality of services where poor workers live—while at the same time in the informal (and less productive) sector they can get similar benefits for (or almost for) free. Thus, the end result is an oversized informal/less productive sector in which poor workers are overrepresented in part by choice. One empirical factor that remains to be established is the elasticity relating changes in employment in the informal sector to changes in the relative benefits of social protection.

In addition, given that many workers are willing to work without participating in the formal social security system, incentives for illegal informal employment are exacerbated. Levy estimates that in 2003 around 75% of firms in Mexico were illegal (i.e., noncompliant with their social security obligations), and between 5 and 8 million workers (out of an economically active population of 41.5 million) were illegal salaried workers (the legal informal workers—

¹ The programs considered in the analysis exclude public spending on education, water, and sanitation and other monetary or in-kind transfers.

primarily, the self-employed—comprised 17.7 million; 86, 180–81). Levy argues that in order to avoid fines, a number of activities are broken down into smaller than optimal and less productive units. These firms are less likely to innovate and, thus, even in the absence of capital market imperfections, growth will potentially be lower because investment is allocated to firms that will use more backward technology.

Levy concludes 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” (2). Incoherent social policy is yet another factor that contributes to low growth in gross domestic product (GDP). Using a partial equilibrium labor market model, Levy estimates that the static efficiency costs are between 0.9% and 1.44% of GDP. The combination of suboptimal allocation of employment and investment implies lower growth of productivity and wages for workers in the informal sector. Thus, Levy argues, the present combination of social security and social protection policies ends up hurting poor workers in the form of forgone higher wages in the future. The counterpart of an oversized informal sector is lower social security revenues collected by the government, which, in turn, limits the ability of the government to extend formal social security coverage, making it more difficult to eliminate the existing horizontal inequity over time. As for vertical equity, Levy argues that up to 2.36% of GDP is redistributed, but some of that is from future to present generations and not from high- to low-income households.

In order to eliminate the perverse incentives and their negative impact on formal employment, productivity, and growth, Levy proposes to replace the current mix of social insurance with a system of universal benefits funded out of the government’s general revenues. The universal benefits would include most of those in the current social security system (housing and day care programs are among those excluded), and the financing would come from an increase in the current value added tax (VAT) to 15% across the board (including the elimination of current exemptions such as those pertaining to food and prescription drugs). The poor would be compensated for the negative impact associated with higher consumption taxes via monetary transfers.

The only question that is left open in an otherwise comprehensive and methodic discussion is the distributive impact of the proposed reform. Under Levy’s proposal, formal workers would lose some of their current benefits and would have to pay for the universalization of core benefits in the form of higher consumption taxes. While it is true that consumption taxes are “progressive” in absolute terms (i.e., the absolute amount paid is positively associated with income), they are regressive in relative terms, the common way to determine whether taxes are inequality increasing or decreasing. In other words, the Lorenz

curve after the increase in consumption taxes will lie below the Lorenz curve before the change everywhere. To compensate the poor for the losses of a higher and universal (no exceptions) VAT, Levy suggests that the government could use a monetary transfer to compensate the poor for their losses. Assuming this could be done, the poorest 20% would gain from the reform. However, that will not be the case for households in other deciles. An assessment of the distributive impact of Levy's reform could shed light on the welfare outcomes for different socioeconomic groups and the potential political support/opposition for such a change.