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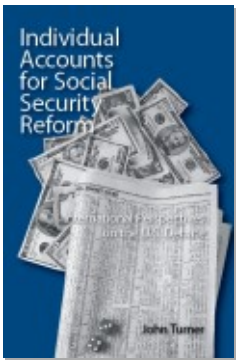
Appendix B. Labor Market Distortions Due to Contribution Evasion and Avoidance



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Appendix B

Labor Market Distortions Due to Contribution Evasion and Avoidance

Contribution evasion occurs when employees and employers do not make required social security payments. This situation is pandemic in the mandatory account systems in Latin America, with only 10 to 60 percent of the workers required to contribute actually doing so (Gill, Packard, and Yermo 2005). (See also the discussion in Chapter 7 of this book.) Even social security in the United States and other OECD countries has substantial underpayment due to workers' participation in the "underground" or "informal" economy (Gillion et al. 2000). While it is difficult for wage and salary earners to evade mandatory social security contributions, it is much easier for self-employed and contract workers, household employees, owners and employees of small businesses, and casual laborers.

Contribution evasion is a problem in both mandatory defined benefit and mandatory individual accounts. Such behavior occurs for several reasons with mandatory individual accounts (Bailey and Turner 2001). First, guaranteed minimum or means-tested benefits reduce the incentive for low-income workers to contribute if the outcome from their payments is not much larger than the guaranteed benefit. In Chile, for example, the provision of a guaranteed minimum benefit after 20 years of contributions may discourage low-wage earners from paying further. To avoid contributing, some workers may move into the informal sector.

Myopic workers prefer not to contribute toward their future retirement benefits and to keep their money for current consumption, regardless of the type of retirement income system. Myopic workers have a high rate of time discount, meaning that they place little weight on planning for future periods. This perspective is a reason why social security programs are mandatory (Gillion et al. 2000). Because myopic workers place little value on future benefits, they are more likely to view required contributions as a tax. As a tax, the contributions would have distortionary effects on their decisions relating to work.

Low-income workers, small firms, and people and businesses in financial distress are more likely to evade making social security contributions because they place higher priority on expenses with more immediate payoff, such as health benefits (Bailey and Turner 2001). Low-income workers may feel that

the level of the mandatory contribution rate is too high and not contribute for that reason.

The efforts of employers and workers to evade social security contributions for mandatory individual accounts may affect labor market outcomes. Employers may hire some workers informally, paying them in cash, rather than as part of the official payroll. Doing so not only eliminates contributing to social security, it deprives workers of labor market protections of law. Similarly, employers may claim workers are contractors rather than employees, which would also have the dual effect of evading contributions and withholding labor protections provided to employees.

Contribution evasion for mandatory individual accounts may be easier in some jobs than in others and may affect one's choice of employment. People may work in the underground or informal economy in part to evade mandatory social security contributions and taxes.

Contribution avoidance is closely related. While contribution evasion is the illegal failure to make mandatory contributions, contribution avoidance occurs when workers and employers take legal steps so as not to be required to contribute. Contribution avoidance occurs when employers structure work and payment so that the people who work for them will not be classified as employees. It also occurs when firms structure compensation in order to reduce the part that is covered by social security. This can be done by small enterprise owners when they take compensation as profits rather than as wages.

Contribution evasion and avoidance may take place because of the effect of taxes and social security payments when collected together. Thus, social security contribution evasion often is an aspect of income tax evasion. It may distort labor market activity, which has resultant welfare costs.

Contribution evasion is only possible when the government fails to enforce mandatory contributions. In Chile, for example, it is the employers' responsibility to ensure that their workers contribute, but the government makes little effort to enforce the mandatory contribution law. Lax enforcement in other Latin American countries is evident from the low participation rates there as well (Gill, Packard, and Yermo 2005).