

Does formal work pay? The role of labor taxation and social benefit design in the New Member States

Johannes Koettl (World Bank and IZA) and Michael Weber (World Bank)

Abstract

The analysis presented in this paper defines three different synthetic measurements of disincentives for formal work: two standard measurements, namely the tax wedge and the marginal effective tax rate (METR); and a new, innovative measurement called formalization tax rate (FTR). The novelty of the latter is that it not only measures disincentives stemming from labor taxation, but combines it with disincentives stemming from benefit withdrawal due to formalization. A descriptive analysis across a large number of OECD and Eastern European countries reveals that the disincentives for formal work—when measured through the FTR—is especially high for low-wage earners. This suggests that formal work might not pay in this segment of the labor market, in particular for the so-called mini-jobs and midi-jobs (low paying part-time work). Another novelty of the paper is the econometric analysis that complements the descriptive analysis. Using EU-SILC 2008 data and OECD Tax and Benefit data for six Eastern European countries (Bulgaria, Czech Republic, Estonia, Latvia, Poland, and Slovakia), the paper matches disincentives for formal work that depend on income and family type to individual observations in a large data set. More precisely, EU-SILC data is matched with individual synthetic measurements of disincentives for formal work—namely the tax wedge, METR, and the FTR—coming from the OECD Tax and Benefit model. Applying a probit regression, the analysis finds a significant positive correlation between FTR or METR and the incidence of being informal. In other words, controlling for individual and job characteristics, the higher the FTR or the METR that individuals are facing is—that is, the higher disincentives for formal work—the more likely they are to work informally. The tax wedge, on the other hand, yields a negative correlation, suggesting that the tax wedge is not sufficiently capturing disincentives for formal work for neither microeconomic nor cross-country analysis.

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