

The World Bank

# Promoting Formal Employment in Kazakhstan

Overview

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## Overview<sup>1</sup>

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The Government of Kazakhstan is concerned with informal employment. The reasons for the concerns are threefold. First, informality means that many workers lack adequate social security. Second, informal employment is deemed to be of low-productivity, and as such hampers the modernization of the Kazakh economy. Finally, informality implies less budget revenues and accordingly lower provision of public services. The promotion of formal employment is thus a way to enhance social welfare. A higher share of formal employment is considered a sign of a more modern and better performing economy.

The objective of this report is to inform the discussion of informality in Kazakhstan, and to contribute to the development of an evidence-based policy to promote formality. To this end the report examines four broad issues. First, it determines the size and profile of informal employment in Kazakhstan. Second, it identifies main obstacles to formality. Third, it assesses the potential gains from formalization. And fourth, it recommends ways to promote formal employment in Kazakhstan. In addition, the report points to areas where further research is needed in order to better understand the nature and causes on informality in Kazakhstan.

The report argues that the size of informal employment is not excessive in Kazakhstan given its level of economic development and the industrial structure. Informal employment is heavily concentrated in agriculture and as such is “normal” for an industrializing country with a still large rural economy. The share of non-agricultural informal employment, although significant, is much smaller. Contrary to the dominant perception, informal employment is not tantamount to self-employment. In fact, over half of informal workers in Kazakhstan are wage employees in both formal and informal firms. At the same time many self-employed run a registered business. The report finds that majority of informal jobs require low skills and are of low productivity. However, the proportion of informal jobs that require high skills and are well paid is non-negligible. The report further argues that the main cause of informality in Kazakhstan is the high costs of doing business, which induces firms to exit the formal

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<sup>1</sup> The note was prepared by Jan Rutkowski. Guidance and comments were provided by Jesko Hentschel (Sector Manager) and Sebnem Akkaya (Country Manager). Useful comments were received from the peer reviewers Gordon Bechermerman and Diego Angel-Urdinola as well as by Emanuel Salinas Munoz and Yeraly Beksultan. This overview summarizes the main findings of five JERP technical notes, which are jointly referred to as the report. The report encompasses the following notes: “The Size and Profile of Informal Employment in Kazakhstan”, “Causes of Informal Employment in Kazakhstan”, “Reaching for Higher Social Insurance Coverage in Kazakhstan”, “Costs of Informality in Kazakhstan. Revenues, Productivity, Social Insurance”, and “Policies to Reduce Informal Employment. An International Survey”.

sector and limits opportunities for formal employment. In addition, many workers lack skills that would allow them to take higher productivity formal jobs. Also the existing social protection system provides limited incentives to contribute. In contrast, labor regulations are not a significant obstacle to formality.

It is neither feasible nor desirable to formalize all informal jobs, and some informality is “natural” and bound to remain. Still, there is substantial scope to increase the share of formal employment in Kazakhstan. The report recommends a two-pronged strategy to promote formality. First, to reduce the costs of doing business in order to encourage firms to move to the formal sector, and to create more and better jobs. Second, to invest in human capital in order to reduce the skills gap and equip workers with skills demanded in the modern sector of the economy. These recommendations are in line with the Government’s own policy priorities. In particular, the Government has recently initiated ambitious reforms intended to improve the business environment. Substantial progress has already been made in reducing the costs of doing business, nonetheless there is room for further improvements.

Some questions remain unanswered. The evidence on obstacles to formality is partial or circumstantial. More research is necessary to identify the specific causes of informality and to develop effective policies to lower the costs of doing business in Kazakhstan. We also need to better understand the nature of the skills gap and the way it hinders formal employment. And more research is necessary to determine the barriers to labor mobility and the ways of encouraging it.

This overview is organized as follow. Section I presents estimates of the size and profile of informal employment in Kazakhstan. Section II examines the causes of informality. Section III discusses the costs of informality and potential gains from formalization. Section IV looks at the policy implications of the analysis and recommends ways to promote formality. Section V lists poses questions for the future and lists issues that require further research.

## I. Size and Profile of Informal Employment

1. This section assesses the size of informal employment in Kazakhstan and looks at the characteristics of informal jobs and workers. It focuses on informal employment outside agriculture as it is non-agricultural jobs that are amenable to formalization. In contrast, the reduction of agricultural informal employment is a matter of industrialization and economic development, which goes beyond the scope of this report.

2. **This report measures informal employment in Kazakhstan using the Labor Force Survey.** There may be different criteria used to identify informal employment, and the results will vary depending on the choice of the criterion. This implies that there is no single “right” measure of informality and thus there is bound to be some ambiguity in the measurement of informality. The main report discusses the sensitivity of results with respect to the definition of informality.

3. **The report uses the following criteria to define informal employment.** In the case of *wage employment*, the primary criterion is the payment of social security contributions. The secondary criterion is written employment contract. In the case of the *self-employment* the criterion is enterprise registration. Contributing family workers and workers who work on subsidiary household plots

(*podvor'e*) are by assumption considered informally employed. Box 1 presents the main concepts and the estimates of the size of main categories of informal employment in Kazakhstan.

4. **Informal employment represented one-third of total employment in Kazakhstan in 2009.** However the size of informal employment varies depending on the criteria that are used to define formality. Under the most strict criterion, whereby formally employed are only workers who enjoy *all* benefits of formality, informal employment accounts for about 57 percent of total employment. Under the most relaxed criterion, whereby formally employed are all workers who enjoy at least *some* benefits of formality, informal employment accounts for about 26 percent of total employment. The range of variation is thus wide and shows that the estimates of the size of informal employment are sensitive to changes in the criteria used to define formality.

5. **The size of informal employment is not excessive given the Kazakhstan's level of economic development.** Although comparable data on the share of informal employment across countries are not available, the existing estimates of the size of the informal economy suggest that the size of informal employment in Kazakhstan is in line with its level of GDP per capita, and the industrial structure (particularly, a high share of agricultural employment). For example, according to widely used estimates by Schneider (2010), the informal economy in Kazakhstan accounts for a similar share of GDP as in Brazil or Russia and for a lower one than in Ukraine.

6. **The majority of informal workers in Kazakhstan are employed in agriculture and informality is concentrated in rural areas.** Close to 70 percent of all informal workers live in rural areas and over 60 percent work in agriculture. The largest group among the informal workers is contributing family members: household employment accounts for a half of total informal employment. Informality is thus to a large extent driven by a high share of agriculture in the Kazakh economy. Agricultural employment and informal employment largely overlap.

7. **Informal employment outside agriculture is much smaller.** It represents 18 percent of total non-agricultural employment and 17 percent of urban employment. There are thus two main types of informality in Kazakhstan: large agricultural and rural informal employment and much smaller non-agricultural and urban informal employment.

8. **The nature of non-agricultural informality is different from that of agricultural.** The causes are different, and so are policies to promote formality. Agricultural and rural informality is to a large extent "natural" and reflects the predominantly traditional character of the agricultural sector in Kazakhstan. Small scale agricultural activity has historically been informal, that is not subject to taxation and government regulations. Given its traditional character, agricultural employment can hardly be formalized in Kazakhstan. In contrast, non-agricultural informality is largely caused by various barriers to formality, such as taxes, regulations, and bureaucracy. Here there is scope for formalization by reducing the costs of doing business in the formal sector. Non-agricultural firms and workers can move from the informal to the formal sector.

### Box 1. Informal employment: main concepts and categories

This box defines main terms used in the note. Figure 1 shows a simple categorization of informal employment used in this paper.

**The informal economy** is the part of an economy that is not taxed, monitored by any form of government or included in gross national product (GNP). Alternatively, the informal economy is defined as all currently unregistered economic activities that contribute to the officially calculated (or observed) GNP. The size of the informal economy is usually measured as a percentage of the official GDP (Schneider 2010).

**Informal employment** comprises of the total number of informal jobs, whether carried out in formal sector enterprises, informal sector enterprises, or households, during a given reference period. Informal employment comprises:

- Own-account workers and employers employed in their own informal sector enterprises.
- Contributing family workers, irrespective of whether they work in formal or informal sector enterprises.
- Employees holding informal jobs, whether employed by formal sector enterprises, informal sector enterprises, or as paid domestic workers by households.
- Members of informal producers' cooperatives.

**Informal sector.** This is a narrower concept than that of the informal employment. It excludes persons holding informal jobs in formal sector enterprises (see figure 1).

**Figure 1. Informal employment in Kazakhstan, 2009**  
(percentage shares in category's total)

<b>Informal Employment (33.2%)</b>			
Non-agricultural (38%)			Agricultural (62%)
Wage workers (53%)		Self-employed (47%)	
Formal firms <sup>b)</sup> (60%)	Informal firms <sup>a)</sup> (40%)		
Informal employment outside informal sector	Informal Sector		

a) Firms that employ up to 10 workers and do not pay social security contributions on behalf of their employees.

b) Firms that employ more than 10 workers and do not pay social security contributions.

Source: Hussmans (2004), Perry and others (2007), Schneider and others (2010), Bank staff analysis.

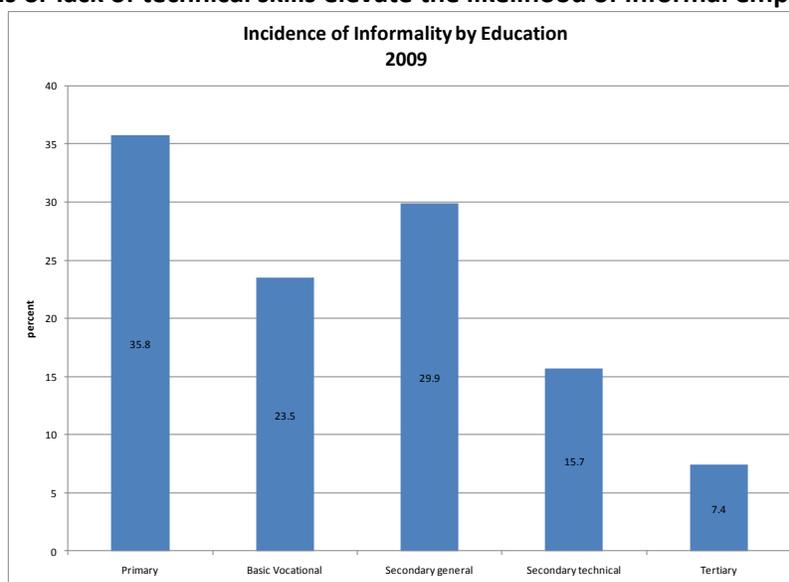
9. **Agricultural employment in subsistence farms is bound to remain informal. In contrast, non-agricultural jobs are amenable to formalization.** In order to reduce agricultural informality the Government needs to support industrialization and job creation in the modern sector of the economy, and to encourage labor mobility. This is a longer-term process associated with economic development. To reduce non-agricultural informality the Government needs to reduce the costs associated with the transition from the informal to formal sector: lower taxes, relax regulations, and reduce bureaucracy. Non-agricultural formality can be promoted in the short- to medium-term by using a set of standard policy tools (see Section IV). However, it should be emphasized that policies that reduce the costs of

doing business in the formal sector contribute not only to the promotion of non-agricultural formal employment but also to the reduction of agricultural informal employment. This is because by fostering job creation in the modern formal sector they create better employment opportunities for rural workers migrating to urban areas.

10. The remaining part of this overview focuses *non-agricultural* informality as this is the type of informality that is the most relevant from the perspective of short- to medium-term economic policy.

11. **Who are the informal workers outside agriculture?** What is their profile and to what extent is it different from that of formal workers? Compared with formal workers, informal workers tend to be younger and have lower educational attainment. They are also more likely to live in rural areas. There are no gender differences: women are as likely to be informally employed as men. Table 1, panel A presents detailed data on the composition and incidence of non-agricultural informal employment by worker characteristics. Figure 1 presents the close link between low skills and the probability of informal employment. Low skilled workers are much more likely to be informally employed than the more skilled ones.

**Figure 1. Low skills or lack of technical skills elevate the likelihood of informal employment**



Note: Non-agricultural employment.

Source: Labor Force Survey 2009; Bank staff calculations.

12. **Contrary to the common perception, informal employment is not tantamount to self-employment.** After all, it is wage employees that represent the dominant part (53 percent) of the non-agricultural informal employment, while the self-employed represent 44 percent (the rest are contributing family workers). However, the incidence of informal employment is indeed much higher among the self-employed than among the wage workers. Only 12 percent of wage workers are employed informally, compared with as much as 44 percent of the self-employed (table 1, panel B).

13. **Among the informal wage employees the majority work in formal rather than informal firms.** The available information does not allow one to determine the precise figures. But assuming that larger

firms (employing more than 10 workers) as a rule are formal, we find that about 60 percent of informal wage workers are employed in formal firms, while the remaining 40 percent in informal firms. This needs to be put into perspective, however. Informal employment represents a small part of total formal sector employment: only one out of twenty workers in *formal* firms is employed informally. It pays some formal firms to employ workers on an informal basis, and thus avoid paying labor taxes, although the scale of this phenomenon is rather small. Our analysis shows, however, that there is barely any room in Kazakhstan to lower labor taxes or to relax labor regulations. Hence, promoting formal employment in the formal sector requires a different set of measures (see Section IV).

14. **Most of informal jobs outside agriculture are of low productivity.** Informal workers tend to be employed in less skilled occupations. The single largest occupational group is the less skilled non-manual workers, followed by the manual and unskilled workers (table 1). Informal jobs tend to be low-paid. The median informal worker earns 13 percent less than his/her formal sector counterpart.<sup>2</sup> And the incidence of low-pay is much higher among the informal workers than among the formal ones. About 27 percent of informal workers are in the bottom quintile of the earnings distribution compared with 19 percent of formal workers (figure 2). Furthermore, most of informal workers (close to 70 percent) are employed in the market services sector, mainly in trade and restaurants; that is in the traditional, less productive sector of the economy. Finally, the vast majority (85 percent) of informal workers are employed in micro and small firms. Job characteristics of informal workers are thus very much different from those of formal workers (table 1, panel B).

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<sup>2</sup> The difference in total compensation is larger because by definition the compensation of formal workers includes social security contribution.

**Table 1. Distribution and Incidence of Non-agricultural Informal Employment, 2009**  
**Panel A. Worker characteristics**

	Distribution		Informality rate
	Formal sector	Informal sector	
	<i>Percent</i>		
Total	100.0	100.0	17.7
<i>Location</i>			
Urban	69.8	66.1	16.9
Rural	30.2	33.9	19.4
<i>Sex</i>			
Men	50.7	50.9	17.7
Women	49.3	49.1	17.6
<i>Age</i>			
15-24	12.0	18.6	25.0
25-54	80.2	75.1	16.7
55-64	7.8	6.3	14.8
<i>Education</i>			
Primary	1.3	3.5	36.2
Basic Vocational	10.0	14.5	23.6
Secondary general	19.9	40.2	30.4
Secondary technical	32.0	27.9	15.8
Tertiary	36.8	13.9	7.5

**Table 1. Distribution and Incidence of Non-agricultural Informal Employment, 2009**  
**Panel B. Job characteristics**

	Distribution		Informality rate
	Formal sector	Informal sector	
	<i>Percent</i>		
<i>Status in employment</i>			
Dependent	88.0	53.2	11.5
Self-employment	12.0	44.3	44.3
Household	0.0	2.5	100.0
<i>Occupation</i>			
Professionals	31.2	4.5	3.0
Technicians	14.8	6.6	8.8
Non-manual	16.5	47.1	38.2
Agricultural	0.3	1.1	45.5
Manual	22.7	21.5	16.9
Unskilled	14.7	19.1	21.8
<i>Economic activity</i>			
Industry	27.6	22.3	14.8
Market services	45.0	67.7	24.4
Non-market services	27.4	10.0	7.3
<i>Firm size</i>			
Micro (1-10 employees)	10.5	39.7	25.3
Small (11-50)	36.7	44.6	9.8
Medium (51-250)	34.5	12.5	3.1
Large (250+)	18.4	3.2	1.5

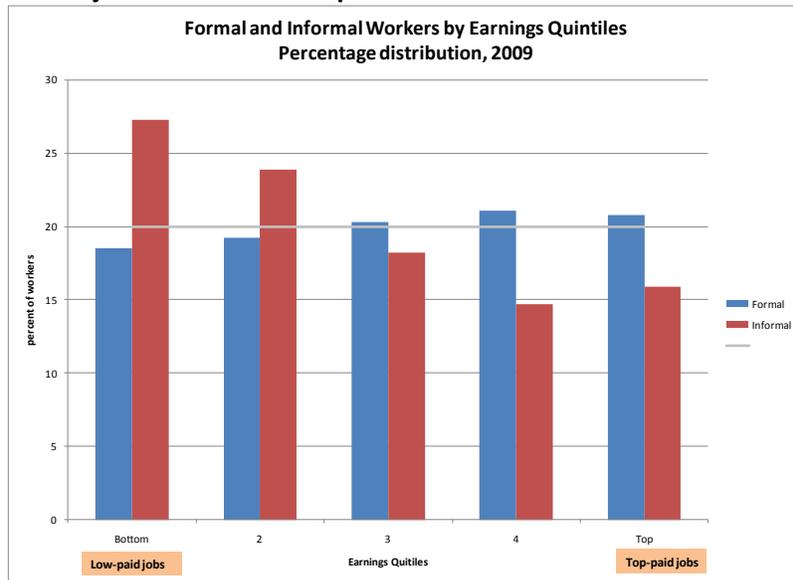
Note: Population 15-64.

Informality rate: informal workers as a percentage of total employment.

Source: Labor Force Survey 2009; Bank staff calculations.

15. **The upper-tier informal employment is small but non-negligible in Kazakhstan.** Although most informal jobs are of low productivity, there is also a fraction of jobs that require high skills, and are well rewarded, and thus presumably are highly productive. Nearly 5 percent of informal employment is in professional occupations, and close to 7 percent in occupations requiring advanced technical skills (table 1, panel B). Earnings of top paid informal workers are somewhat lower (around 10 percent) than their formal counterparts, but still 16 percent of informal workers is in the top earnings quintile (figure 2). It is thus important to appreciate the heterogeneity of the non-agricultural informal sector in Kazakhstan. It consists of a large lower-tier segment, which covers low-skilled, low-paid and low productivity jobs in the traditional sector, and a smaller upper-tier segment, which covers highly skilled, well-paid jobs in the modern sector of the economy.

**Figure 2. Informal sector jobs tend to be low-paid**

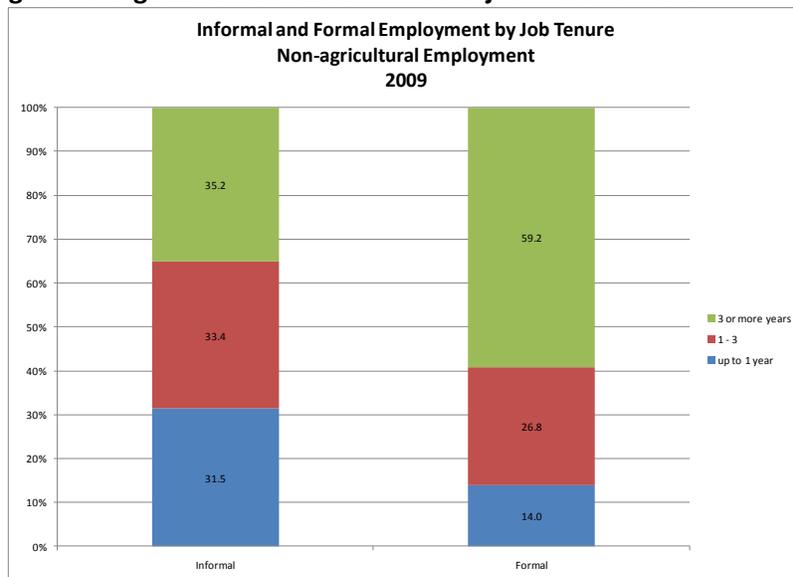


Note: Non-agricultural employment.

Source: Labor Force Survey 2009, Household Budget Survey 2009; Bank staff calculations.

16. **Informal jobs are high turnover jobs.** The hiring rate for informal jobs is much higher than for formal ones. In the informal sector the share of workers with job tenure less than one year (which is a proxy for the hiring rate) is over two times higher than in the formal sector (figure 3). One informal worker in three holds his/her job for no more than one year. This means that entry into informal employment is much easier than into formal employment. At the same time this means that informal jobs tend to be temporary and precarious.

**Figure 3. The hiring rate is high in the informal sector but job tenure is short**



Note: Non-agricultural employment.

Source: Labor Force Survey 2009; Bank staff calculations.

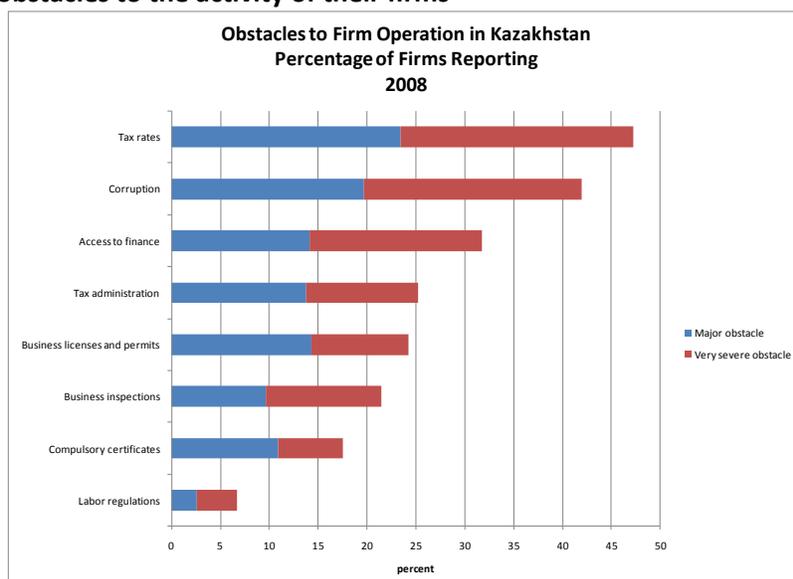
17. **To conclude, for the most part the non-agricultural informal sector provides employment of last resort.** Informal workers tend to be less educated and less skilled than formal sector workers, and accordingly tend to hold low-paid, low-productivity jobs, largely in the traditional services sector. However, there is also a relatively small but non-negligible upper-tier informal employment in Kazakhstan. Some of the informal jobs require high, often professional skills, and are well-paid. Informal workers also tend to be younger than formal ones, which suggests that for youth informal employment is often a stepping stone to formal employment. Understandably, non-agricultural informality is predominantly an urban phenomenon, nevertheless the incidence of non-agricultural informality is higher in rural than in urban areas. Wage employees and the self-employed are almost equally represented among informal workers, although expectedly the self-employed are much more likely to be informally employed than wage employees. The majority of the informal wage workers seem to be employed in the formal enterprises, and this pattern has important policy implications that are discussed later.

## II. Causes of Informality in Kazakhstan

18. In theory, firms opt-out of the formal sector in order to avoid taxes, regulations, and bureaucratic harassment. Workers choose informal employment either because they cannot find jobs in the formal sector, or because the benefits of formal employment fall short of costs. This section examines the actual causes of informality in Kazakhstan. It argues that the main cause of informality in Kazakhstan is the high costs of doing business in the formal sector. This causes firms to exit the formal sector and limits the number of formal jobs. Workers are thus pushed into informal employment by the lack of jobs opportunities in the formal sector. But also many informal workers lack the skills that would enable them to take more productive formal sector jobs. Furthermore, the availability of universal social protection benefits limit incentives to contribute. In contrast to business regulations, labor regulations are not found to create significant disincentives for formal employment.

19. **According to Kazakh employers, the biggest obstacles to the operation of their firms are tax rates and tax administration, access to finance, corruption, business licenses and permits, and finally inspections** (figure 4). These are the factors that are likely to discourage some firms from entering the formal sector. Especially small employers may prefer to remain informal in order to avoid the attendant costs of formality. At the same time, if access to finance is viewed as difficult, then firms have less incentives to enter the formal sector because the benefits of formality are deemed too small to justify the costs.

**Figure 4. Kazakh employers see high tax rates, corruption, difficult access to finance, and bureaucratic barriers as major obstacles to the activity of their firms**



Source: IBRD-World Bank BEEPS 2008; Bank staff calculations.

20. In order to identify the obstacles to formality in Kazakhstan we also compared different aspects of the business environment across countries. **The benchmarking exercise revealed six critical obstacles to formality in Kazakhstan.** These are (a) starting a business, (b) informal payments, (c) access to finance, (d) business inspections, (e) business licenses and permits, and (f) compulsory certificates. It is these areas where the potential to improve incentives for formality is the greatest. Box 1 presents in a nutshell the main messages of this section using the example of compulsory certificates.

21. **Starting a business is relatively difficult in Kazakhstan.** In the last year the Government reformed business registration procedures and made it easier to start a business.<sup>3</sup> After all, Kazakhstan is among the top reformers in this area. However, despite the recent improvements, there is room to further ease the business registration process. The number of procedures (seven) that the prospective entrepreneurs need to follow is still higher than in many other countries in Europe and Central Asian (ECA). And the time necessary to complete the business registration process is still rather long. For example, it takes 20 days to register a business in Kazakhstan compared with just 3 days in Georgia or six days in Turkey (figure 5). Registering a business is a critical step leading to formalization and therefore facilitating the process is an important means toward promoting formalization of small firms and the self-employed.

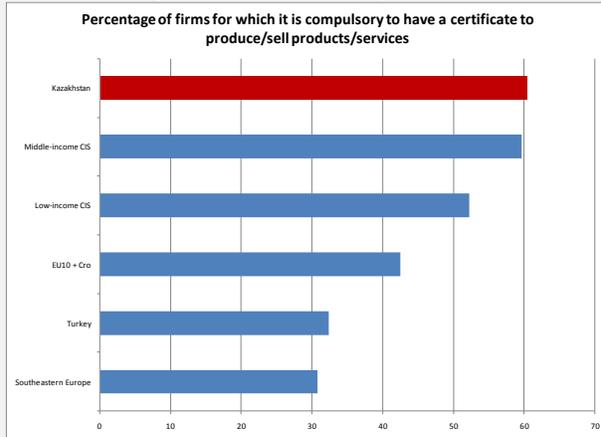
<sup>3</sup> The Government continues to simplify business registration procedures. According to the new regulations that went into force in June 2010 registration of SMEs must be done within one day. The number of procedures to start a business decreased to 6, which is below the ECA average, although still slightly above the OECD average.

**Box 1. Compulsory certificates in Kazakhstan: An example of a bureaucratic burden that raises the costs of formality and may be conducive to informality**

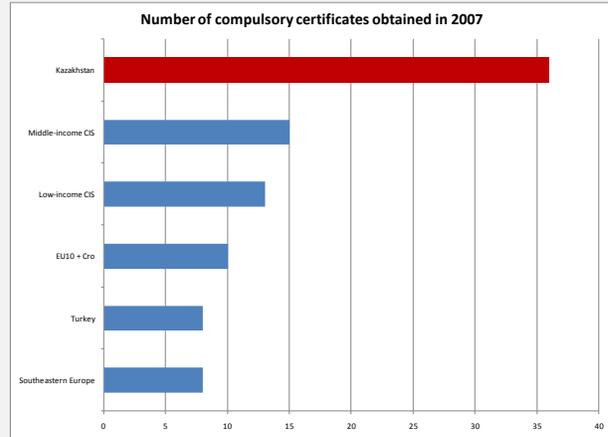
Compulsory certificates are an example of a bureaucratic barrier that may discourage formalization in Kazakhstan. Apparently, the cost of obtaining these certificates is significantly higher in Kazakhstan than in most other countries in the ECA region. As many as 60 percent of Kazakh firms need to obtain the certificates to produce or sell their products or services (figure A, panel A), and the number of certificates is high (panel B). In addition, obtaining these certificates is time consuming and often associated with informal payments (panels C and D). Informal payments cost Kazakh firms quite a lot: in total they account for 6.5 percent of total annual sales, more than in most other countries in the ECA region. Thus, being formal can be costly in Kazakhstan. For some firms – especially small ones – it may be too costly, and such firms are likely to prefer to opt-out from the formal sector.

**Figure A Costs of formality: compulsory certificates**

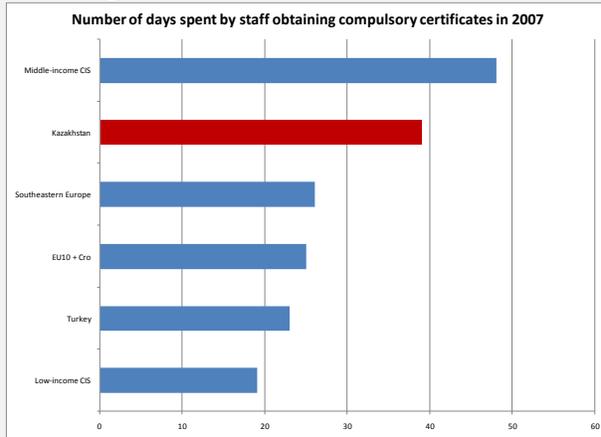
Panel A. Most of Kazakh firms need to have certificates to produce or sell their products



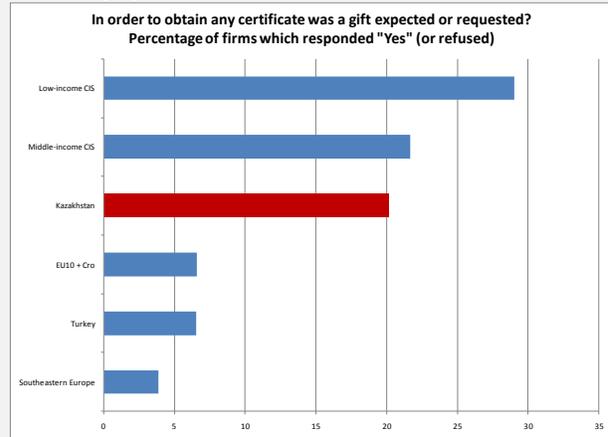
Panel B. Kazakh firms need to have more certificates than firms in other ECA countries



Panel C. Obtaining certificates is more time consuming in Kazakhstan than in other countries



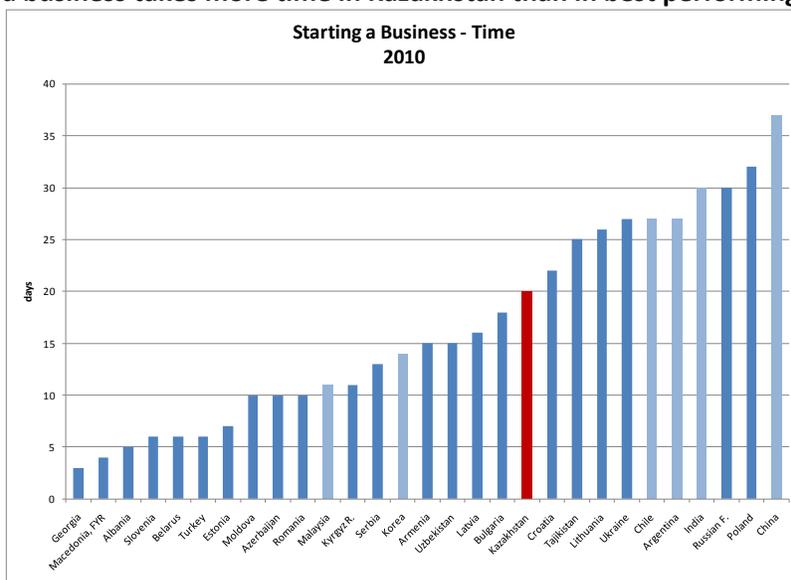
Panel D. Obtaining certificates is often associated with informal payments in Kazakhstan



Source: IBRD World Bank Business Environment and Enterprise Performance Survey, 2008.

Source: Bank staff analysis

**Figure 5. Starting a business takes more time in Kazakhstan than in best performing countries**



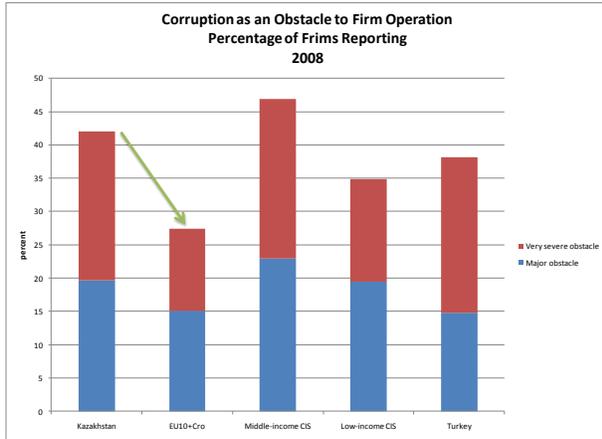
Source: World Bank Doing Business online database, December 2010.

22. **While the costs of formality tend to be higher in Kazakhstan than in comparator countries, the benefits seem to be less.**<sup>4</sup> For example, figure 6 panel B shows that Kazakh employers cite business inspections as an important obstacle much more frequently than their counterparts in EU10+Cro countries and in Turkey. Figure 7 shows that access to finance is more often seen as difficult in Kazakhstan than in the benchmark countries. Relatively difficult access to finance means that the *benefits* of formality are smaller than in the comparator countries. At the same time the perceived *costs* of formality – the costs associated with informal payments, inspections, licenses, permits and certificates – are higher than in comparator countries. This implies that the incentives to exit the formal sector seem to be stronger in Kazakhstan than in EU countries and, to a lesser degree, Turkey.

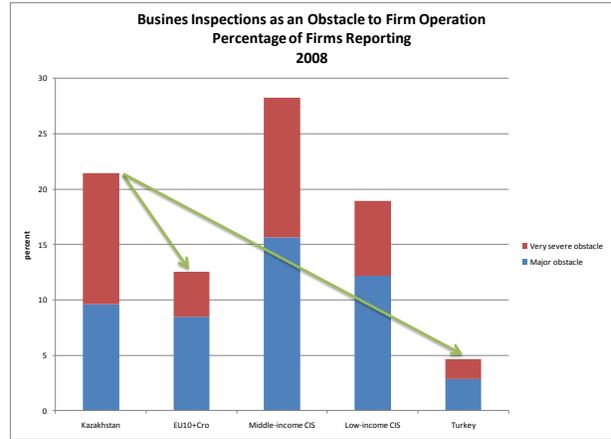
<sup>4</sup> The benchmark countries, against which the performance of Kazakhstan is compared, are the ten new EU member states (including Croatia) and Turkey. The new EU member states are denoted as EU10+Cro and include Bulgaria, the Czech Republic, Croatia, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Slovenia. Additional comparator countries include middle-income CIS countries (Belarus, Russia and Ukraine) and low-income CIS countries (Armenia, Azerbaijan, Georgia, Kyrgyzstan, Moldova, Tajikistan and Uzbekistan)

**Figure 6. Critical obstacles to formality in the eyes of employers: Kazakhstan against other ECA countries**

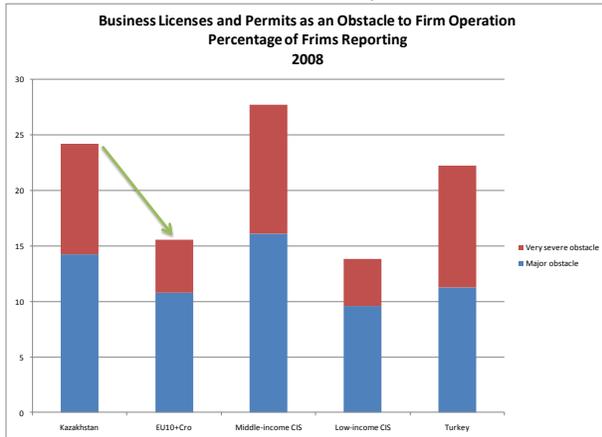
**Panel A. Corruption**



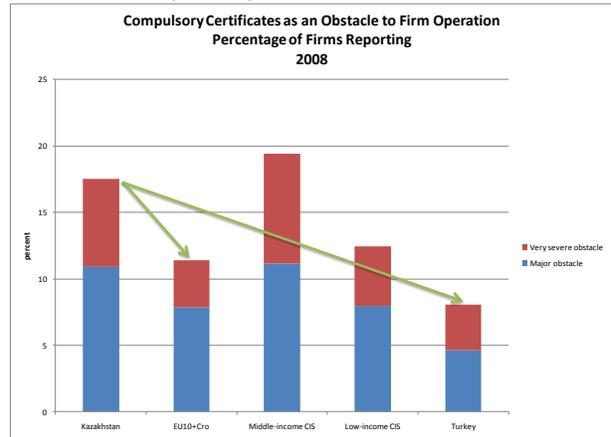
**Panel B. Business inspections**



**Panel C. Business licenses and permits**

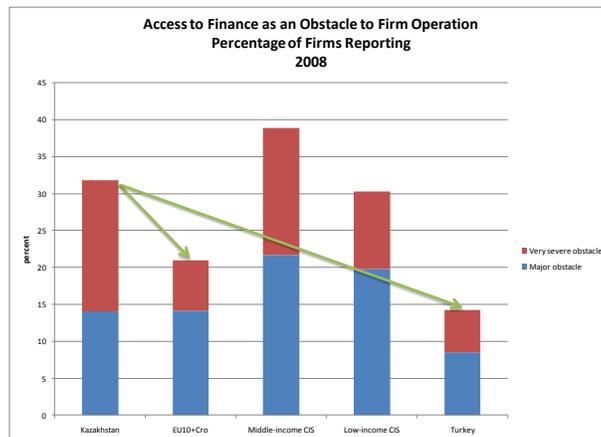


**Panel D. Compulsory certificates**



Source: IBRD-World Bank BEEPS 2008; Bank staff calculations.

**Figure 7. Kazakh employers more often view access to finance as difficult than employers in EU10+Cro countries and Turkey**



Source: IBRD-World Bank BEEPS 2008; Bank staff calculations.

23. **Objective indicators of the business environment in Kazakhstan are consistent with the subjective perceptions and support the conclusion that high the costs of doing business are a disincentive for formality.** For illustration, the staff of an average (median) Kazakh firm spends one month on obtaining permits, compared with 10 days in EU10+Cro and 7 days in Turkey. And obtaining permits takes on average 3 months in Kazakhstan, which is twice as long as in EU10+Cro and over three times as long as in Turkey.<sup>5</sup> In order to obtain the required permits Kazakh firms often need to make informal payments. About 30 percent of Kazakh firms claimed that an informal payment was expected or requested for any permit application. Such claims were made by only about 10 percent firms in EU10+Cro and Turkey. Permits are inherently associated with corruption, which is an additional factor that discourages firms from entering the formal sector. Lengthy inspections impose additional burden on Kazakh firms. And again, the costs associated with inspections are high compared with other countries. Inspections are often associated with informal payments in Kazakhstan, more often so than in other countries in the ECA region. In the case of tax inspections about 26 percent of Kazakh firms had to make informal payments, while only some 5 percent of firms in EU10+Cro or in Turkey.

24. **Labor regulations hardly inhibit formal employment in Kazakhstan.** Few Kazakh employers view them as an important obstacle (figure 4). International benchmarking also indicates that hiring and firing costs are not unduly high in Kazakhstan compared with other countries. The *difficulty of redundancy index* is at a moderate level in Kazakhstan (30 on a scale from 0 to 100 according to the World Bank Doing Business database, 2010). The minimum wage accounts for less than 20 percent of the average wage and is low by international standards. At such a low level it is unlikely to discourage formal hiring. Finally, taxes on labor (social security contributions and personal income tax) are modest in Kazakhstan by international standards. The so called *tax wedge* on labor accounts for 10 percent and is not only well below the ECA average but also low by international standards, lower than for example Korea or Malaysia (World Bank Doing Business 2010).<sup>6</sup>

25. **Although taxes on labor are low in Kazakhstan they may still provide a disincentive for firms to hire workers formally.** It is most likely labor tax evasion that accounts for the fact, that some *formal* firms employ workers on an informal basis (about 5 percent of total formal sector employment). However, there is hardly any space to reduce the already low social security contributions and the personal income tax.<sup>7</sup> Therefore efforts to reduce informal employment in formal firms must rely on administrative measures and sanctions for noncompliance with tax regulations (see Section IV below).

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<sup>5</sup> The Government recognizes the problem and intends to simplify the procedures necessary to obtain permits and licenses, shorten the processing time, and limit the number of permits. It is planned that 331 out the total of 1015 permits will be eliminated. The relevant laws are planned to be adopted by the end of 2011.

<sup>6</sup> The tax wedge is the difference between the total labor cost to employer and the net take home pay of workers, expressed as a percentage of the labor cost. The difference between total labor cost and the net take home pay amounts to the sum of social security contributions and the personal income taxes.

<sup>7</sup> In addition to social security contributions labor costs can be raised by mandatory benefits that the employer by law has to provide to formally employed workers. Whether such benefits play a significant role in discouraging formal hiring in Kazakhstan still needs to be determined.

26. **The design of the social protection system does not provide sufficient incentives for workers to contribute and thus supports informal employment.** In particular, the low-income self-employed workers do not gain much in terms of social security benefits by paying contributions. This is because for such workers the difference between non-contributory universal social assistance benefits and contributory social insurance benefits is small. In particular, small is the difference between the base universal pension and the retirement pension based on contributions. In this case strengthening the incentives for formal employment would require widening the gap between social insurance and social assistance benefits (while ensuring the adequate level of social protection for the whole population).

27. **Lack of adequate skills is a factor that prevents some workers from taking formal sector jobs and pushes them into informal employment.** As documented earlier, formal jobs tend to require higher skills than informal jobs. At the same time, the majority of informal workers have low education and skills. The incidence of informality is particularly high among workers with elementary education and workers with secondary general education. These workers lack vocational or technical skills that would allow them to take more productive formal sector jobs. In fact, BEEPS data indicate that inadequately educated workforce is one of the top constraints to the operation of Kazakh firms. Over 50 percent of employers report workforce skills as a major or severe constraint, which is more than in most ECA countries. Low skilled workers are thus bound to low productivity informal employment. In this sense low skills are an important factor behind informality in Kazakhstan.

28. **Informal employment is also a result of poor job prospects in the formal sector.** The informality rate tends to be higher in regions where the unemployment rate is high and job vacancies are scarce. Under such conditions the informal sector provides employment of last resort. Workers are pushed into informal employment by the lack of job opportunities in the formal sector. Faster job creation in the formal sector is thus a necessary condition for promoting formal employment. This in turn requires improvements in the business environment and the lowering the costs of doing business in the formal sector (see Section IV below).

29. **To conclude, there are four main causes of informal employment in Kazakhstan.** First, the high costs of doing business, which discourage some firms from operating in the formal sector. Second, and as a result of the first, limited job opportunities in the formal sector which force some workers into informal employment. Third, limited gains in social protection benefits associated with formal employment, especially in the case of low-earnings workers. Finally, lack of adequate skills, which prevents less educated workers to take more productive formal sector jobs, and condemns them to low productivity informal employment. Unlike in many other ECA countries, labor regulations are not unduly strict and do not seem to be a factor behind informality in Kazakhstan. Taxes on labor may create incentives for informal employment for both workers and firms, however they are low by international standards and there is little space to lower them.

### **III. Costs of Informality**

30. **Informal employment tends to be of low productivity, leads to losses in budget revenues and means incomplete social security coverage.** These are the costs of informality. Would the formalization of existing informal jobs bring about substantial gains in social welfare? The report argues

that the immediate gains from formalization would be limited, and lower than the notional costs. There are several reasons for this. First, not all jobs can be formalized and some informal employment is bound to remain. Second, some of the informal jobs would disappear if they were formalized because of the higher labor costs. As a result, the gain in budget revenues would be smaller than the estimated budgetary losses. For the same reason smaller than expected would be the increase in social security coverage. Third, by and of itself formalization would hardly enhance the productivity of existing jobs. It is the reallocation of jobs and labor from less to more productive uses that would bring about productivity gains.

31. **Still, formalization is by all means a worthwhile objective to pursue.** As argued earlier, the primary policy to foster formalization is to lower the costs of doing business. Such policy brings about long-term gains: investment, firm growth and job creation. The dynamic gains from the growth of formal employment thanks to the better investment climate outweigh the static gains from the formalization of existing jobs.

32. **Budget revenue losses.** If all informal jobs were formalized, total government revenues would be up to 5 percent higher and total tax revenues would be 8 percent higher. However, this is a purely hypothetical case. The actual gains from formalization would be considerably smaller. About half of the cost shown above stems from agricultural informality. A large part of agricultural employment in Kazakhstan is in subsistence farming and the bulk of informal workers there are unpaid household members. This type of employment can hardly be formalized. There is no formal sector equivalent for household plot employment and accordingly there is no scope for formalization in the sense of workers moving from informal jobs to *similar* formal jobs. The costs resulting from informal employment outside agriculture are more straightforward. They represent up to 2.6 percent of total budget revenues and 4.0 percent of tax revenues. In contrast to agricultural employment, non-agricultural informal employment is more amenable to policy action. But still the number of formalized jobs would be smaller than the number of informal jobs due to the costs associated with formalization. Some firms would not employ workers if they had to pay social security contributions, as labor costs would become too high. But also some of the informal workers would not take formal jobs offering the same wage as their informal jobs, because they would have to pay income taxes and as a result their take-home pay would become too low. For these reasons the figures represent upper bound estimates of the budgetary costs of informality, and the actual costs are significantly smaller. It is informal *wage employment* that is the source of the largest loss in budget revenues. As much as 63 percent of the revenues loss is attributable to informal wage employment, and only 37 to informal self-employment. Accordingly, the biggest gains in terms of budget revenues growth could be expected from policies aimed at strengthening incentives for firms to operate and hire workers formally.

33. **Productivity differentials.** On average, formal workers earn substantially more than informal workers. However, this is because formal workers have better education and higher skills and thus hold more productive jobs than informal workers. It is not the case that formal jobs *per se* are more productive than informal jobs. In fact, informal jobs are roughly as productive as formal jobs with similar skill requirements. This implies that formalization of employment by and of itself would hardly enhance labor productivity. The gains in labor productivity from workers moving from informal to

similar formal jobs would be negligible. The analysis presented in the main report shows that formal workers do not earn more, and are not significantly more productive than similar informal workers. Informal jobs in Kazakhstan are of low productivity because they are located in less productive sectors of the economy and require lower skills, rather than because they are informal. It is not informality that is the source of low productivity, but the low productivity of jobs held by informal workers.

34. **Social security coverage gaps.** About one-third of the employed in Kazakhstan are not eligible for social insurance benefits because they do not contribute to the social insurance scheme. This is a large group of vulnerable workers, who are at an elevated risk of poverty, especially in the old-age. Although everybody who reached the retirement age is eligible to a flat rate social pension, regardless of their employment history and contribution record, the amount of the pension is currently only 50% of the minimum wage/subsistence level. The risk of poverty is further increased due to the fact that most of the informal workers hold low-paid jobs.

35. **The single largest group of workers who lack social insurance coverage is subsistence farmers and contributing family members, who account for nearly 50 percent of all uninsured workers.** Informal wage employees account for 28 percent of the uninsured and the self-employed for 23 percent (figure 8). As regards subsistence farmers and their family members the extension of social insurance coverage is not straightforward. They are part of the informal sector by the very nature of their employment. Incomes of subsistence farmers as a rule are low, which does not leave much space for taxation. In Kazakhstan this category of informal workers is covered by universal social assistance programs (including social pension), which play the poverty prevention role. As regards the self-employed and informal wage employees, the extension of social security coverage requires the formalization of the employment status. The relevant policies are discussed in the next section.

**Figure 8. Informal workers not covered by social insurance, 2009**

Contributing family members	Self-employed	Wage employees
<ul style="list-style-type: none"> <li>•1.29 million</li> <li>•17% of total employment</li> </ul>	<ul style="list-style-type: none"> <li>•0.59 million</li> <li>•8% of total employment</li> </ul>	<ul style="list-style-type: none"> <li>•0.72 million</li> <li>•9% of total employment</li> </ul>

Note: Contributing family members include mainly persons working on subsistence farms (podvor'e).

#### IV. Policies to promote formal employment

36. **Policies to promote formal employment consist of lowering the costs and raising the benefits associated with formalization.** They fall into four groups: (a) tax policy, including social security contributions, (b) labor regulations, (c) broader business regulations, and (d) institutional reforms, including sanctions for non-compliance. In the longer run, formality is fostered by economic and institutional development, including human capital formation, wider access to finance, etc.

37. **The choice of an effective policy mix depends on the country specific circumstances.** As argued above, the main cause of non-agricultural informality in Kazakhstan is high costs of doing business and, related, limited job creation in the formal sector. Next, inadequate workforce skills are an

obstacle to formal employment. In addition, some formal firms do not comply with the regulations and hire workers informally. Finally, the availability of universal social assistance benefits weakens the incentives for formal employment. Policies to promote formality in Kazakhstan need to address the existing obstacles. The strategy to promote formality thus need to include five components:

- Reducing the costs of doing business by improving business regulations;
- Supporting job creation in the formal sector;
- Investing in human capital to reduce the skills gap;
- Improving compliance by using transparent, rules-based enforcement;
- Improving incentives for formal employment embedded in the design of the social protection system;

38. **The improvement in the investment climate, and the investment in human capital are the two main pillars of the strategy to promote formality.** The improvement in the investment climate encompasses both the reduction in the costs of doing business and, which is closely related, the support for job creation. The two other policies – the improvement in compliance, and in incentives for formality embedded in the social protection system -- play a supplementary role.

39. **The improvement in the investment climate is a short to medium-term policy priority.** The reduction in the cost of doing and starting business is likely to bring about the biggest gain in terms of formalization, and faster job creation in the formal sector. The main way to lower the costs of doing business is to limit to a necessary minimum the number of compulsory permits, licenses and certificates, and more generally to limit red tape and the discretionary power given to the bureaucrats. This will have an additional benefit of reducing the scope for corruption and will limit the informal payments, which currently represent substantial cost to formal businesses. There is also room to further ease business registration procedures in order to facilitate entry of small firms to the formal sector. Job creation in the formal sector can also be supported by the development of business advisory services and microcredit schemes targeted at small firms.

40. **Human capital investment is a longer-term priority critical to bridge the skills gap that limits firm growth and opportunities for formal employment.** The evidence suggests that there is an oversupply of workers with only general skills and a short supply of workers with technical and vocational skills. The educational system needs to be made more responsive to the changing labor market needs. This requires developing labor market information system that provides data on demand for different occupations and skills. Moreover, employers should be more actively involved in the design of curricula so that school graduates possess the skills that are demanded by the market.

41. **The incentives for workers to contribute to the social insurance scheme can be strengthened by raising the level of contributory social insurance benefits relative to universal social assistance benefits.** This particularly refers to old age pensions. The difference between social assistance and social insurance benefits can be increased by improving the profitability of pension fund investments,

raising the female retirement age, and potentially matching government contributions. However, some of these objectives are not straightforward to achieve (higher profitability of investments) or politically easy (higher retirement age). The pay-off to these measures would be delayed, and the actual impact on informality would much depend on the perception on the link between contributions and benefits.

42. **Administrative measures, such as labor inspections and sanctions for non-compliance should be targeted at formal firms which employ workers on an informal basis.** It is important that enforcement is transparent and rules-based. Administrative measures should be thought of as complementary to, rather than substituting for, efforts to reduce the costs of doing business and strengthen incentives for formality.

43. **As mentioned earlier, agricultural informality needs to be addressed by means of policies specific to the agricultural sector, which are different from those to address non-agricultural informality.** A discussion of such policies goes beyond the scope of this report. However, policies meant to support the growth of a modern formal sector will also create incentives for labor to move from less productive rural and agricultural jobs to more productive urban, non-agricultural jobs. The growing modern urban sector will attract rural workers by offering higher wages and better living conditions. The government can facilitate this process by implementing programs designed to support labor mobility.

44. **The policy to promote formality will bring significant long-term gains in terms of better social protection, productivity and economic growth, even though the scope for reducing informal employment is limited.** Some informal employment is bound to remain in Kazakhstan even if the policies aimed at formalization are successfully implemented. As discussed earlier, not all informal jobs can be formalized. Informal sector is present even in the most developed countries. Informal employment also has some important social and economic functions. First, it provides job opportunities to workers who cannot find jobs in the formal sector. As such – by providing income opportunities of last resort – the informal sector is a social safety net for the poor. Second, informality is often a way to start a business and can be a stepping stone to formality. Therefore the policy objective should be not to eliminate informal employment, but instead to reduce it to necessary minimum by strengthening the incentives for formal employment and supporting the creation of formal sector jobs.

## V. Agenda for future research

45. The analysis of informal employment in Kazakhstan presented in this report has an introductory character. **There are a number of questions that still need to be answered in order to better understand the nature and causes of informality in Kazakhstan.** They include the following ones:

- Specific features of the business environment in Kazakhstan that represent the most important obstacles to firm entry, operation and growth;
- Taxation of labor income and its impact on labor supply and informality;
- Demand for skills, supply of skills and the skills mismatch;

- Barriers to labor mobility;
- Dynamics of informal employment;

46. **Business environment.** In order to develop effective policies to promote formality there is a need to better understand the characteristics of the business environment in Kazakhstan. In particular, there is a need to determine the binding constraints to firm growth and, consequently, job creation in the formal sector. This requires a thorough institutional analysis. Employers' views are also critical. The possible instruments include a specially designed survey of the business environment, and focus groups among employers. Such surveys would provide additional evidence on the constraints to formality to inform policy development.

47. **Labor income taxation.** The tax wedge on labor usually is an important factor behind informal employment. Because of labor taxes informal workers often earn more than formal workers in similar jobs, which may discourage formal employment. An additional factor is the entitlement to monetary benefits (present and future) associated with formal employment compared with informal employment. The present report provides only a cursory analysis of the impact of the labor taxes and benefits on informality in Kazakhstan. It concludes that the tax wedge for an average worker is low. However, an important policy question regards the impact of labor taxes and benefits on incentives for formal employment among different types of workers, and at different wage levels, particularly, below the average wage. Such impact can be determined using the *Tax and Benefit* model developed by the OECD. The model allows one to calculate the so called *formalization tax rate* (FTR), and the *marginal effective tax rate* (METR), which measure the costs for an individual worker associated with formalization, at different wage levels. Specifically, FTR measures the share of informal income that an informal worker has to give up to formalize; METR measures, at a given wage level, how much of an *additional tenge* earned in formal gross wage is taxed away, either as labor tax or in the form of withdrawn benefits. The calculation of the FTR and the MTR using the OECD Tax and Benefit model would help one to better understand disincentives for formal employment created by the tax and benefit system in Kazakhstan.

48. **Skills gap.** This report has found that lack of adequate skills is likely to prevent many informal workers from taking more productive formal sector jobs. However, our knowledge of the exact nature of the skills gap in Kazakhstan is very limited. We know that informal workers tend to have low educational attainment and work in less skilled occupations, but we do not know what the skills that they possess or lack are. Similarly, we know that Kazakh employers complain about the inadequate education of the existing workforce, but we do not know what kind of skills they expect workers to possess, and what kind of skills workers lack. To answer these questions one would need to implement a household based survey of the supply of skills and an employer based survey of the demand for skills. The instruments for such surveys were recently developed under the World Bank international *Skills Measurement Project*. The implementation of both surveys in Kazakhstan would greatly enhance the evidence base for the development of policies aimed at reducing the skills gap. The World Bank plans to carry out a small scale employer survey of the demand for skills in Kazakhstan. It would be useful if this survey could be complemented by a survey of the supply of skills so as to determine the nature of the skills mismatch.

49. **Labor mobility.** Majority of informal workers in Kazakhstan live in rural areas where the opportunities for formal employment are limited. As discussed, the reduction of rural informality requires primarily workers moving from rural areas and agricultural jobs to urban areas and non-agricultural jobs. However, rural-urban migration is limited in Kazakhstan, which in turn limits the scope for the increase in the share of the formal sector. The relevant policy question concerns the barriers to labor mobility. There can be a number of them. One is inadequate skills of rural workers, which makes it difficult for them to find urban employment. Another one is high mobility costs. A related possibility is an underdeveloped housing market, which makes changing residence costly. Mobility may also be limited by poor access to credit. Finally, workers can be discouraged from migrating by the perceived lack of job opportunities in urban areas. Additional research and data collection are necessary to discriminate between these possibilities. And this is important because policy implications differ depending on the relative weight of each of those constraints.

50. **Dynamics of informal employment.** The present report presents a static picture of informal employment. A question that is important for the understanding of the nature of informal employment in Kazakhstan concerns the dynamics of informal employment, or the intensity of flows in and out of informality. Do workers move between the formal and informal sector? What is the probability of a worker moving from an informal to a formal job? To what extent this probability depends on worker and job characteristics (such as sex, age, education, location, firm type)? Is informal employment a stepping stone for formal employment, or a permanent trap? The answers to these questions have important policy implications. For instance, the welfare effect of intensive flows between the informal and the formal sectors is much different from that of informal employment being a dead end street, with low chances to escape. The existing data do not allow one to answer the question of workers moving between the two sectors. However, the dynamic analysis would be made possible if the existing Kazakh Labor Force Survey was extended so as to have a panel design, that is the same persons were observed at different points of time (e.g. at two consecutive quarters). This is an option that is worth considering in Kazakhstan, especially given the fact that many other countries have introduced a panel design to the Labor Force Survey in order to support the analysis of labor market dynamics.