

## How Do Pension Systems Interact with Labor Market Informality?

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In countries with informal and formal jobs, a worker's decision over a type of job is also a pension decision. Because a contribution to the pension system can only be enforced in a formal job, workers in labor markets with informality are greatly affected by their decisions about job type. Only formal workers are saving for retirement in a pension system. To explain the interaction between informal labor and the pension system, we will use Peru as a case study. Peru has high levels of labor informality, around 70%; two types of contributory pension systems; and a non-contributory social pension. Data collected from Peruvian government agencies show that a substantial part of the labor force in Peru is not contributing to a pension system; therefore, when this group retires, they will have a limited pension or no pension at all.

Table 1: Coverage of the pension system in Peru, 2019

Percentage of	Pension design			
	Contributory		Non-contributory	
	Individual acc.	PAYG	Social pension	None
Labor force	19%	10%		71%
Adults over 64 y/o	6%	20%	20%	54%

NOTE: Excludes armed forces pensions and retirees with withdrawals of 95.5% of their pension fund.

SOURCE: SBS (2019), Midis (2019).

This ongoing research aims to explain the mechanisms by which the pension system impacts workers' decisions over formal or informal jobs and, in doing so, the composition of the labor force. A formal job, in most cases, implies a higher paying job that requires a contribution to the pension system. For some workers, saving a part of their salary in an illiquid asset available at the end of their working life (in the form of pensions) might not be preferred (Kaplan & Violante, 2014). Liquidity-constrained workers might be better off choosing to work informally without contributing to the pension system. Using panel data from the Peruvian National Household Surveys (INEI, 2020), this study investigates the factors and mechanism behind the sector decision in a two-asset life-cycle model with endogenous informality. Furthermore, the study also characterizes the two types of pension designs (pay-as-you-go and individual accounts) in a country with high informality to determine what system delivers higher coverage and welfare.

### References

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