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AUTHORS AND/OR EDITORS

[Becerra-Camargo, Óscar Reinaldo](#)

[Morales-Zurita, Leonardo Fabio](#)

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Abstract

This paper analyzes the effect of payroll taxes on the formal sector labor demand in the presence of wage rigidity. In particular, we study the impact of a reduction of payroll taxes on the creation of formal jobs in Colombia, where about 40 percent of formal-sector workers earn the minimum wage. Using a reform that granted tax credits to firms hiring workers younger than 28 years of age, we obtain estimates of the effect of payroll taxes on formal-sector employment and wages. We show that payroll tax incidence is borne by formal-sector employers. The reduction in payroll taxes increased formal-sector employment and did not affect wages. Using the estimation results, we recover an estimate of the elasticity of the formal-sector labor demand between -0.53% and -0.87% .

A 1% decrease in payroll costs would increase employment in the formal sector by between 0.5% and 0.9%. This implication is specific to the Colombian context, where the minimum wage is binding for a large portion of formal sector workers, making it likely that formal labor demand drives these results.