



Informality: Exit and Exclusion

Main conclusions and policy messages

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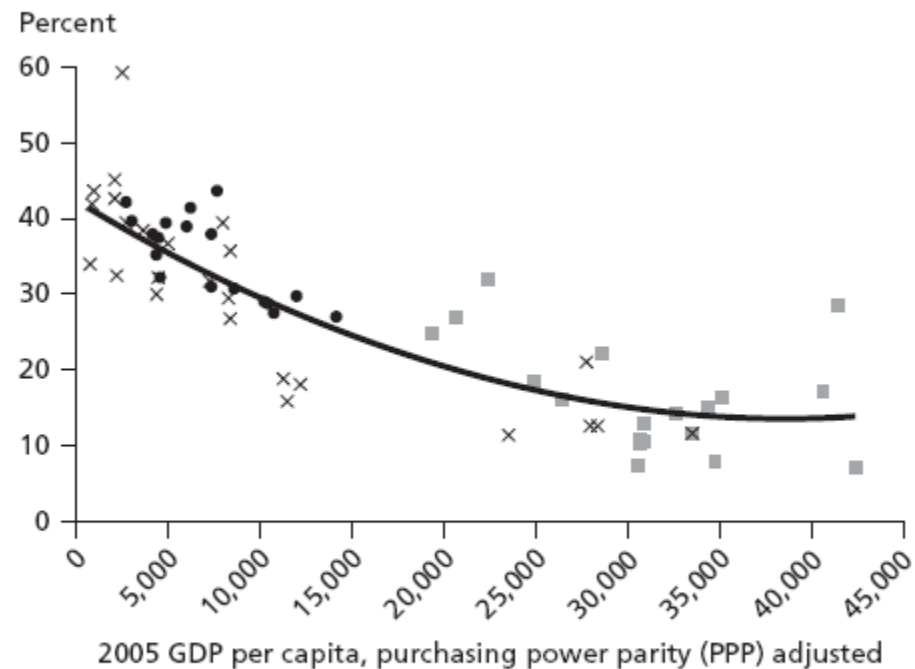
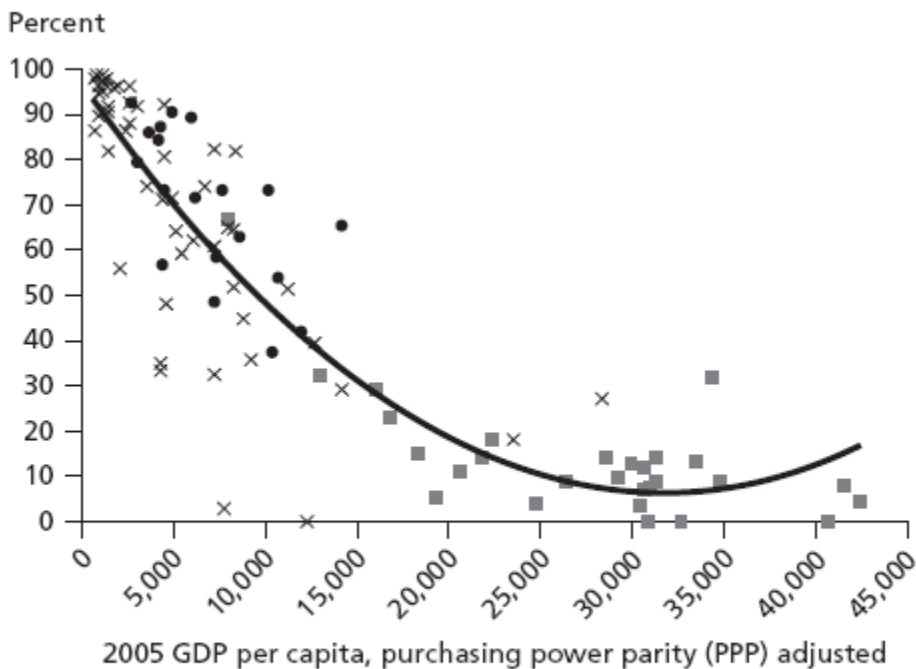
With: Omar Arias, Pablo Fajnzylber, Jaime Saavedra

Informality is both a consequence and a cause of underdevelopment.

Under development explains almost 80% of informality

Share of labor force not covered by a pension scheme

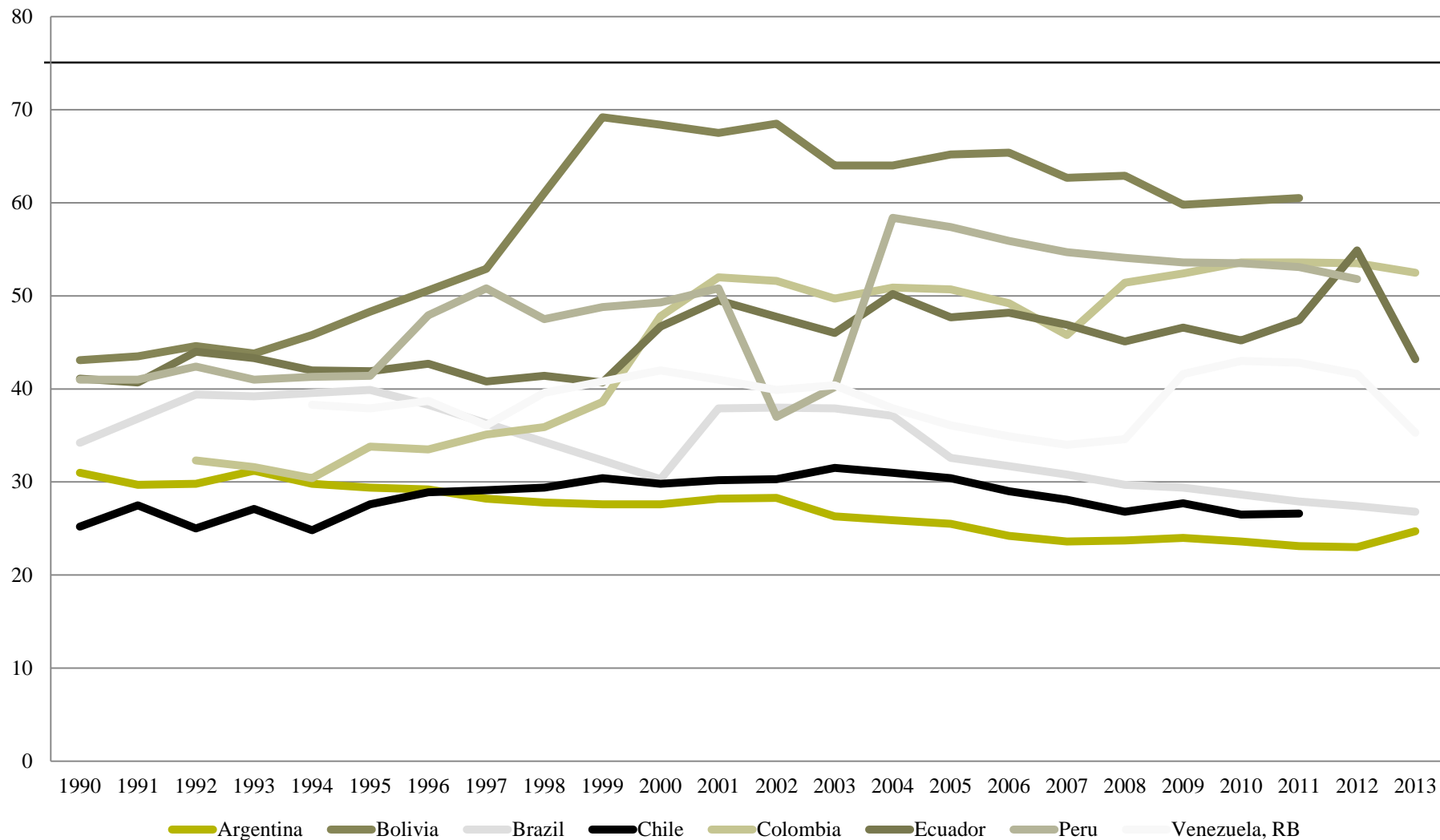
Share of labor force self-employed



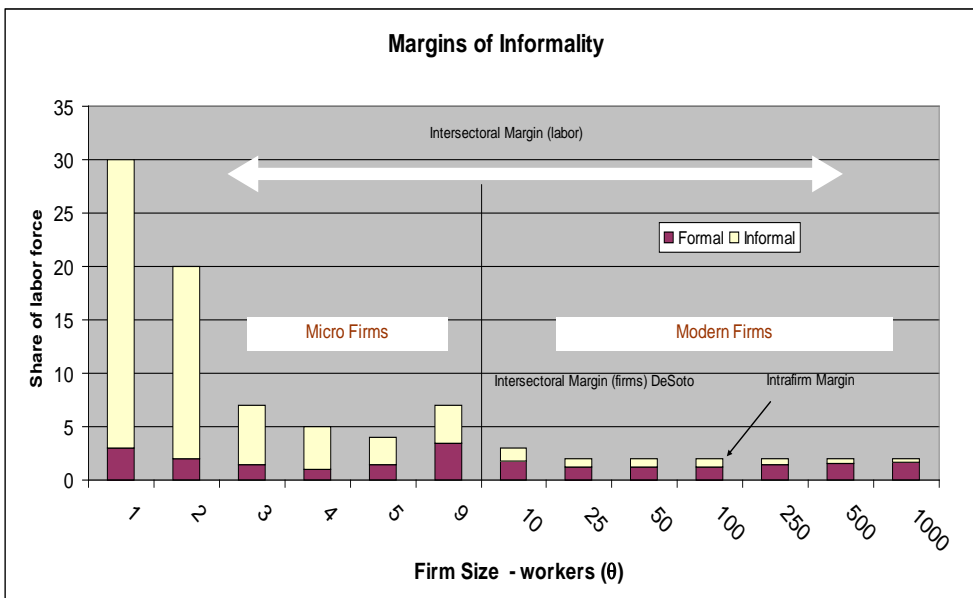
• Latin America ■ Advanced countries × Rest of the world

Sources: Loayza and Rigolini 2006; *World Development Indicators* 2006.

It is particularly high in Latin America



Informality: What and Why?



- **Multidimensional:**
 - Firms, Workers, Tax payers
 - Tax/regulatory evasion/elusion, lack of social protection
- **Due to many factors & motivations**
 - Exclusion
 - Pure evasion
 - Defensive evasion
 - State irrelevance
- **Occurs across multiple margins:**
 - Varying “degrees” of formality
- **Why do we care?**
 - Social protection
 - Productivity
 - Governance, Rule of law
 - Provision of public goods

Main themes from the report

- We need to focus not only on **exclusion**, but **exit** as motivations for informality
 - Many firms/workers are **unable** to become formal due to poor regulations and rigidities **but**
 - Many firms/workers **choose** not to interact with government and opt out of social protection
 - Implies new emphasis on firm/worker **cost benefit analysis** of formality **and other motivations** in addition to understanding regulatory barriers.

- Informality, Distribution, Average Productivity are all reflections of a larger socio-economic equilibrium

The Firm

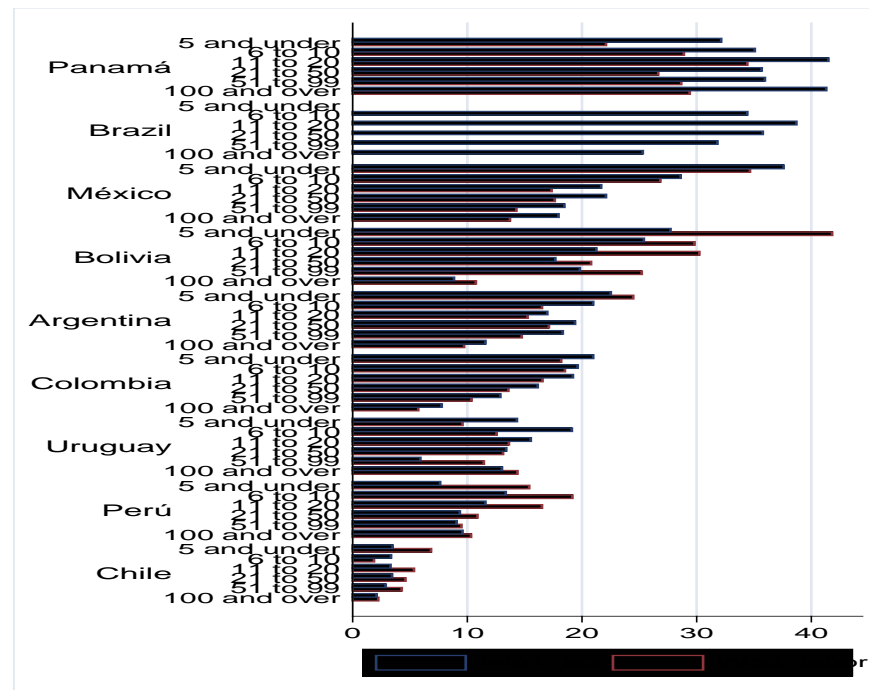
Informality is both a development and a policy issue, with likely consequences on aggregate productivity.

Firm Decisions, Productivity and Growth

- High Informality in “lower-tier” of micro-firm sector:
 - Low productivity, high turnover, young/uneducated firm owners
 - Formality increases with size and growth, links to large firms, fixed location
 - 60-70% owner-only firms informal
 - 20-30% among firms with 5 paid workers
 - ➔ **Growth creates demand for formal services and institutions and increases probability of detection**

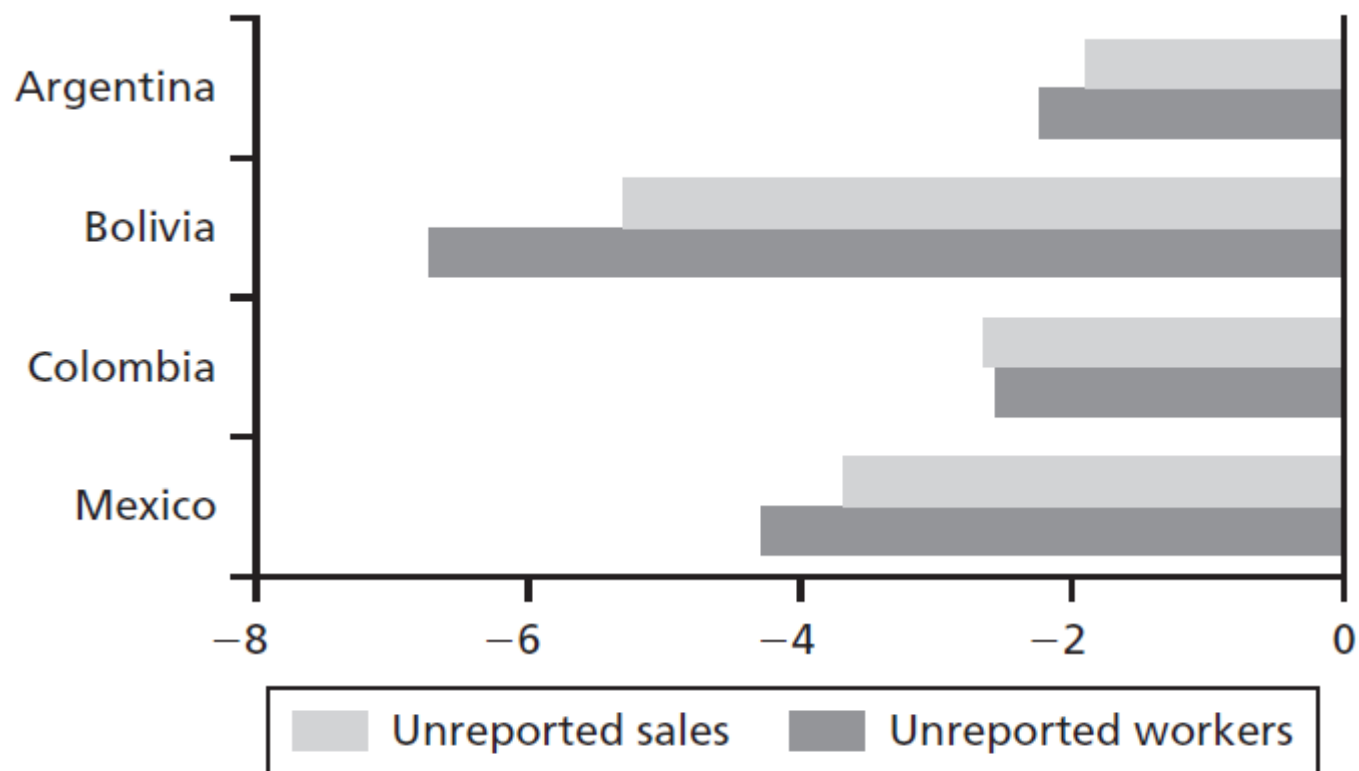
- **But**, informality is also an issue among registered medium & large firms:
 - Non-compliance with (some) government regulations
 - high tax/social security evasion and elusion

Tax & Social Security Evasion in LAC:



Informality is reduced with firm growth

Effects of doubling in size of SME's



Fuente: Perry et al. (2007)

Firm Decisions, Productivity and Growth

□ **Choosing Informality:** a rational cost/benefit analysis

■ Private Costs of Informality:

- risk of fines, bribes: need to remain small to avoid detection.
- lower access to markets, credit, courts, gov't services (eg, SME programs)

■ Private Benefits of Informality:

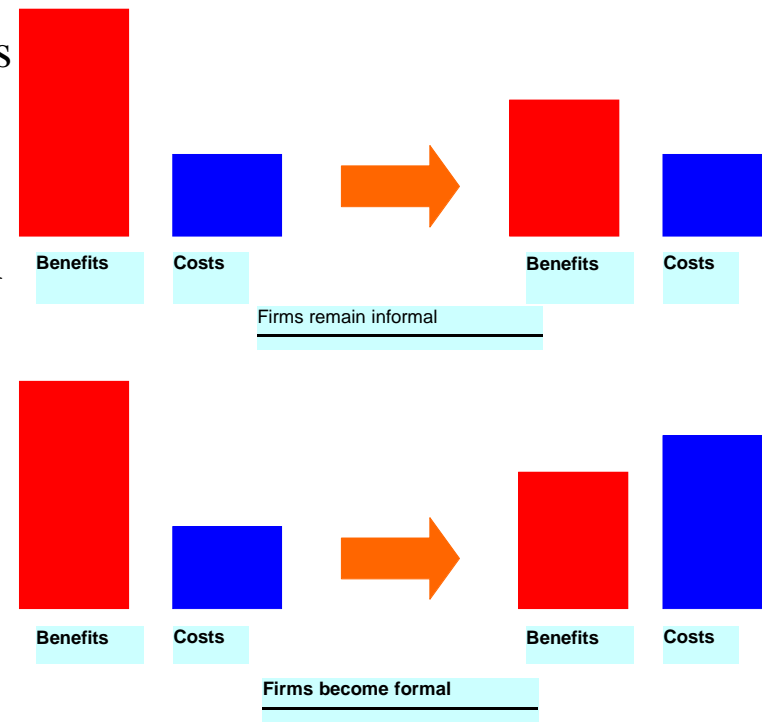
- evade taxes, social security contributions and regulatory burden
- avoid red tape

□ Focus on binding constraints to switch incentives

□ Need integrated policy approach:

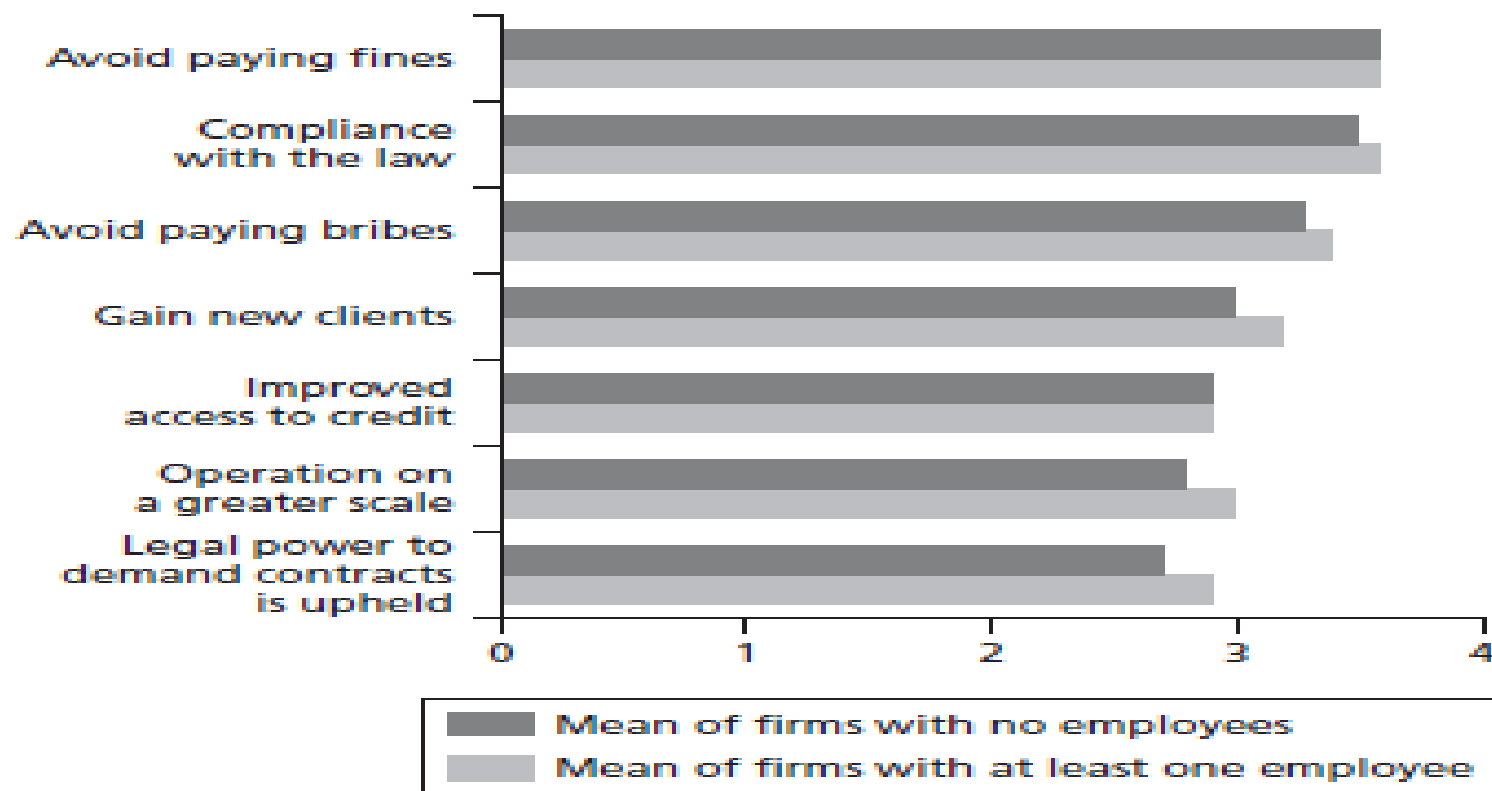
- **“Carrots”**: cut excessive regulations, taxes, red tape, boost access to services for formal firms
- ... and **“sticks”**: increase even-handed enforcement

Benefits and Costs of Informality:



Why firms choose to formalize

Advantages of formalization reported by IFC-surveyed firms



Source: Investment climate surveys 2006.

Firm Decisions, Productivity and Growth

- Cross-country growth effects not always robust (endogeneity problems), though significant micro evidence...
- ...aggregate static and dynamic inefficiencies likely
 - Informality lowers aggregate productivity by reducing average firm size
 - Allows less productive firms to survive (e.g. thanks to tax evasion), so it slows down Schumpeterian creative destruction
 - Limits growth of (potentially larger) informal firms

Impact of Firm Registration in Brazil:

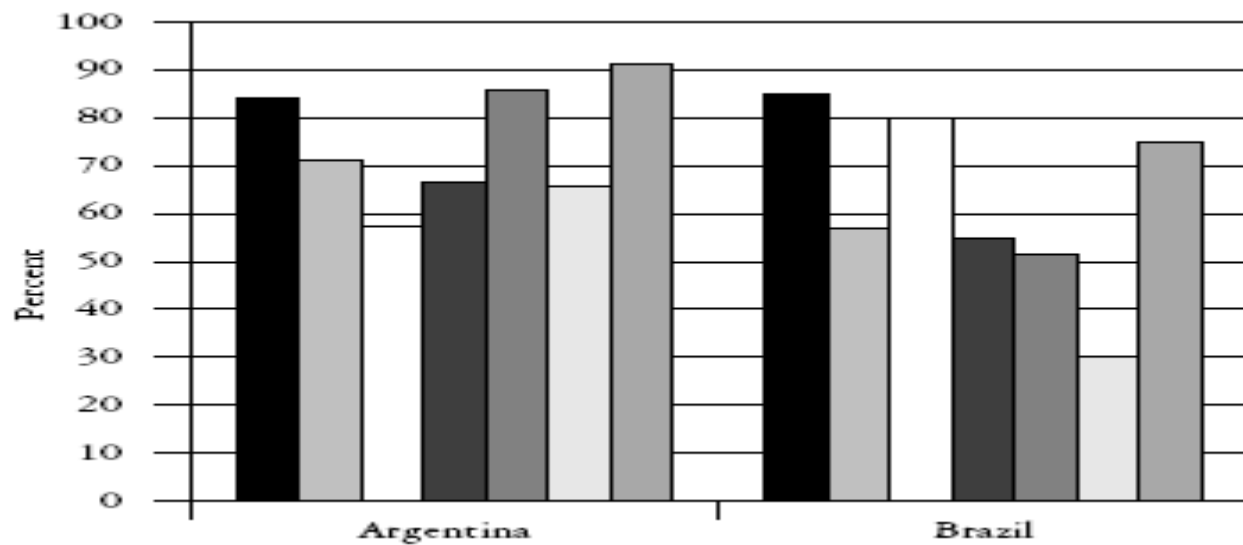


- Corollary: sizable potential gains from policies that:
 - Stimulate firms at the margin to formalize
 - Shift resources away from low productivity informal firms and towards formal sector (largely by increasing productivity and growth of formal sector)

Differences of informality by sector

- 1. Low informality in tradable sectors** (*most of industry, commercial agriculture, oil production, large scale mining*): informal firms can not export –at least directly- and have a hard time competing with imports.
- 2. Higher in non-tradeable sectors where economies of scale are not important:**
 - **High informality** in *subsistence agriculture, cottage industries and handicrafts, retail trade, transport and construction* (though changing)
 - **Low informality** in *telecoms, power, water supply and sewerage, financial services*

Informality by trade-exposure



The Worker

Comparative Advantage and Constraints

2 Views of “Raison d’Etre” of Informal Workers

Dual labor markets:

Exclusion/Segmentation

- Due to
 - Labor market rigidities
 - Skill mismatches
 - Information failures
- Workers rationed into informality-welfare unequal across sectors
- Countercyclical informality

Integrated labor markets

- Workers sort by comparative advantage
 - Preference for entrepreneurship
 - Flexibility (mothers)
 - Low opportunity cost of being informal: low productivity in formal sector & low enforcement
 - Costs/Benefit of social security & social assistance
- Welfare equilibrated across sectors (though not at social optimum)
- Generally pro-cyclical

Both relevant: Relative proportions determined by country-specific institutions and context

Who are the informal, what drives them?

- ~~Apart from firm size~~, strongest predictors: **education, sector, tenure, age, women's household status**. Important differences by country

- Two distinct segments (motivations/characteristics/dynamics), both very heterogeneous:
 - **Independent workers** (self employed, micro entrepreneurs)
 - At least 2/3 voluntary (exceptions: ARG, COL)
 - Lack SS mainly due to 'low incomes' and information failures; low attractiveness of SS and other means of coverage for health insurance
 - **Informal salaried**
 - Most involuntary (exceptions DR, MX): Lack contributions to SS mainly due to employer's decision and/or other means of coverage for health insurance
 - However, near half family members (Survival? Voluntary?)

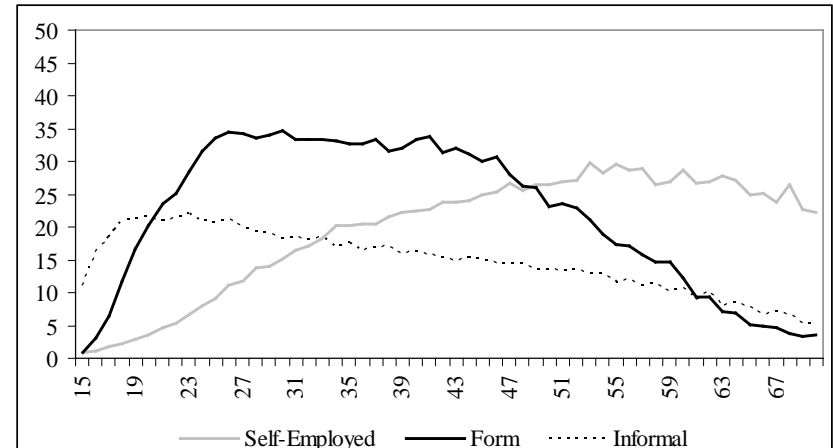
Different Life-Cycle Trajectories

- **Informal Salaried** predominant among youth (**point of entry**, accumulate experience for FS or SE)
- **Self Employment** prevalent among prime or older (K, skills to jump to independence/open a business)

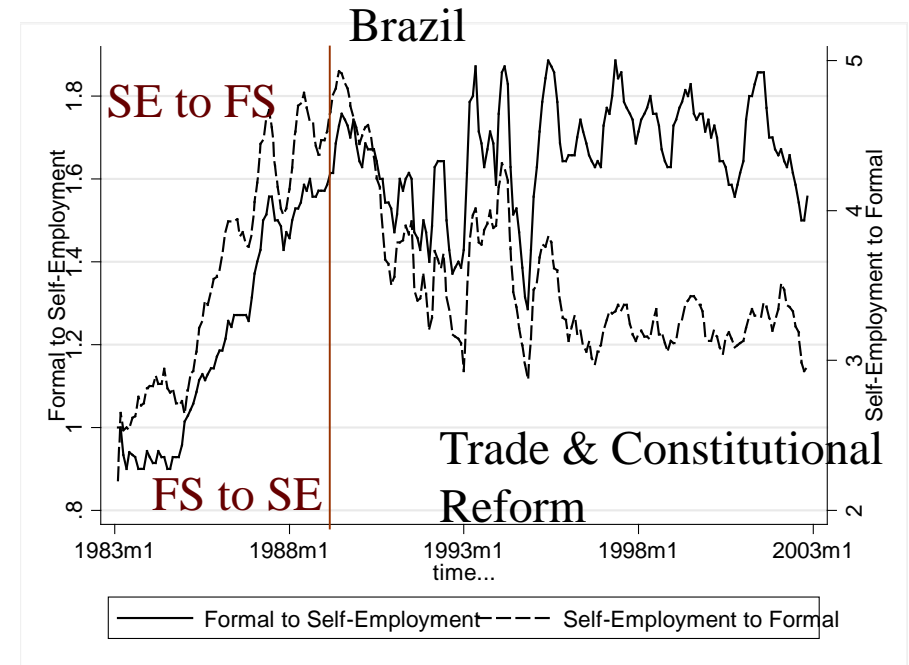
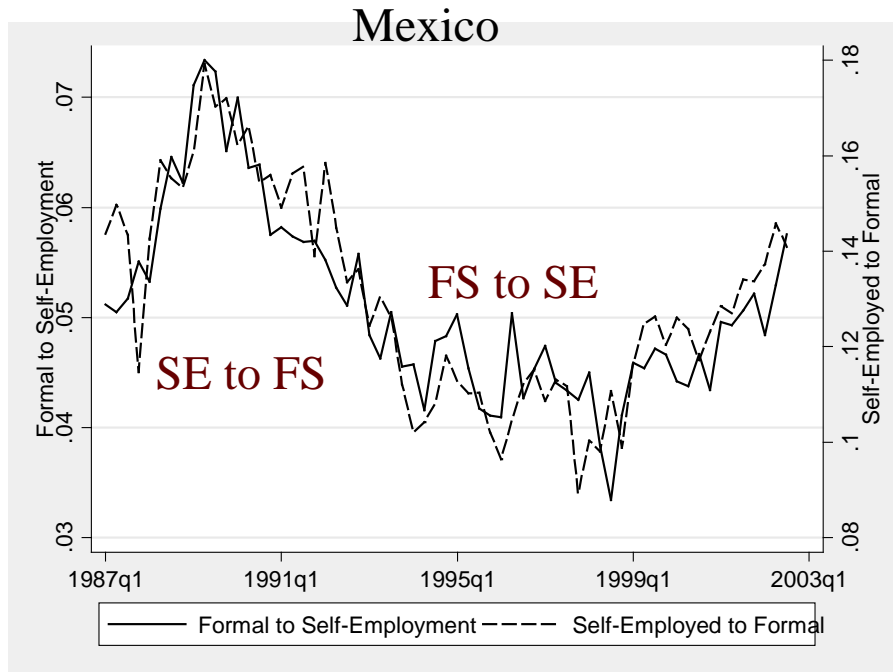
Argentina



Mexico



Gross worker flows suggest substantial labor market integration, though not always



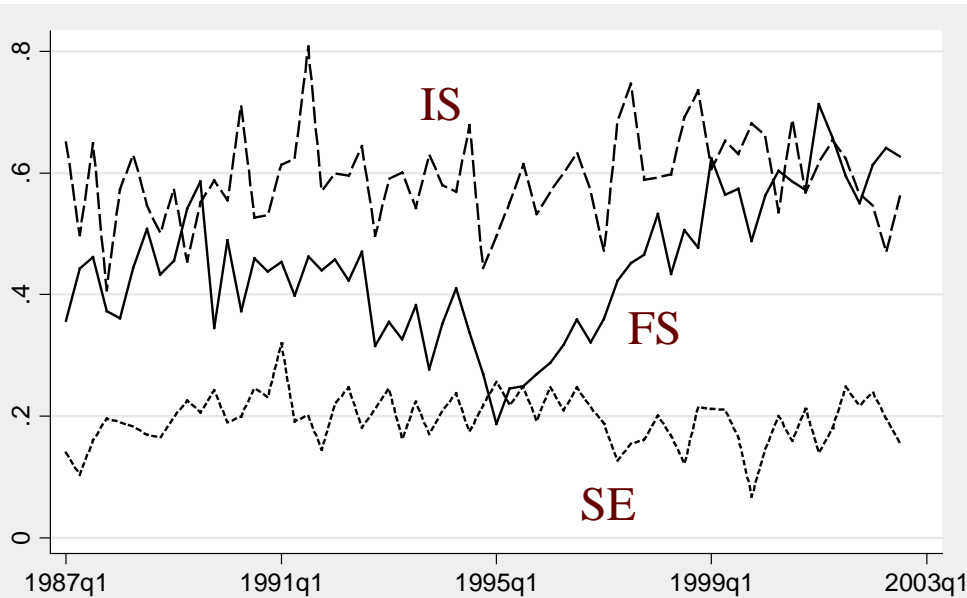
- ❑ **MX: High flows** between FS and SE, FS and IS, highly correlated and **procyclical- more rematching than queuing**
- ❑ **BR: Same until 1990**, then structural change- maybe less voluntary

The Labor Market

Cyclical Behavior and Secular Trends

Cyclical Patterns of Labor Informality

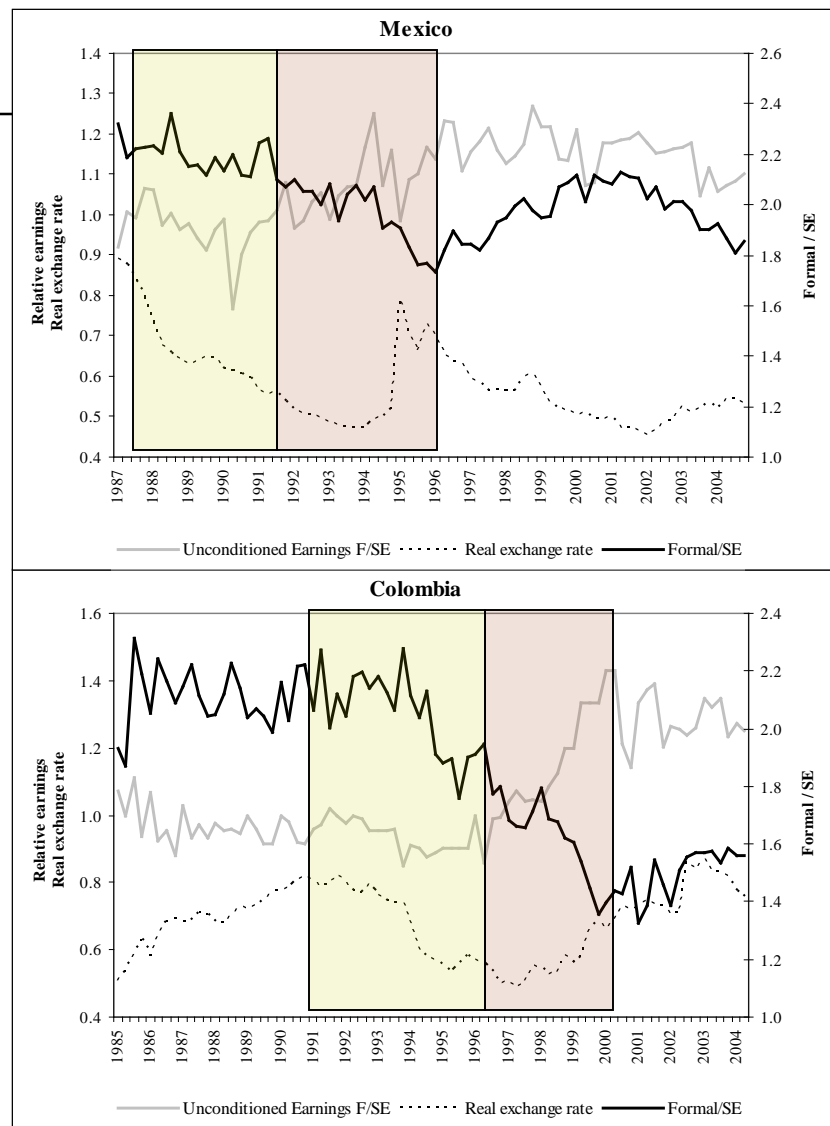
Mexico: Job Finding Rates:
Transitions from U to Work



- Informality tends to be countercyclical
 - However, new insights from OECD literature on why:
 - Job Finding in FS: volatile and pro-cyclical. Rigidities more binding in recessions
 - Job finding in IS and SE sectors more constant.
 - Firing rates more volatile in I, but former effect dominate:
 - Net effect: I-sector absorbs labor in downturns

Cyclical Patterns

- Informality procyclical in some booms
 - Show voluntary entry
 - Depend on positive shocks
 - To Formal/Tradable
 - To Informal/Nontradable
 - FS rigidities less binding in booms
- Increase in Informality in early 1990s
 - Boom in non-tradables
 - REER appreciation due to boom in capital inflows
 - Opening of Capital account, ERBS, improved expectations of future due to reforms



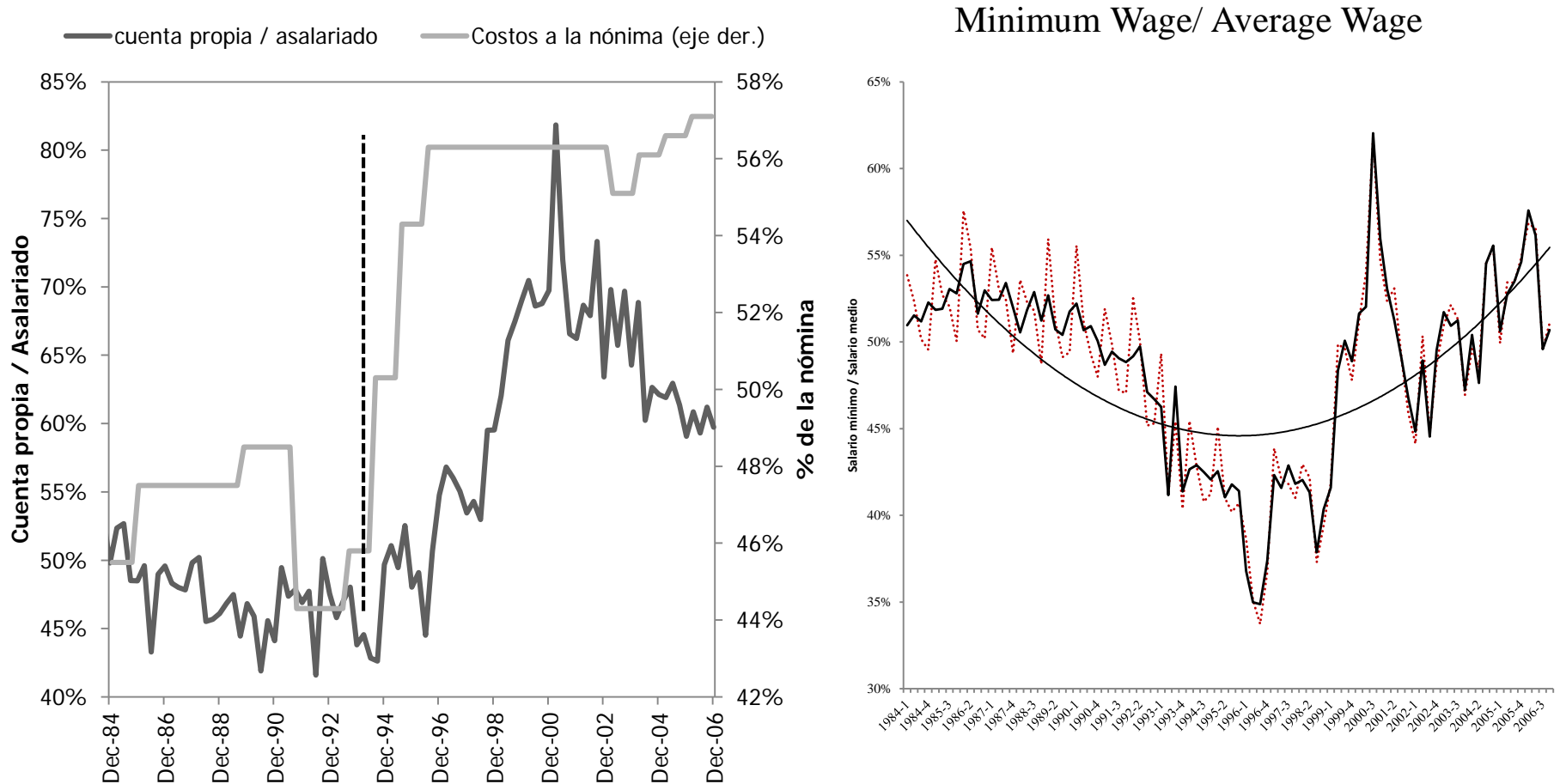
Procyclical/Integrated

Countercyclical/Segmented

What was behind increasing trends in informality in LAC in 90's?

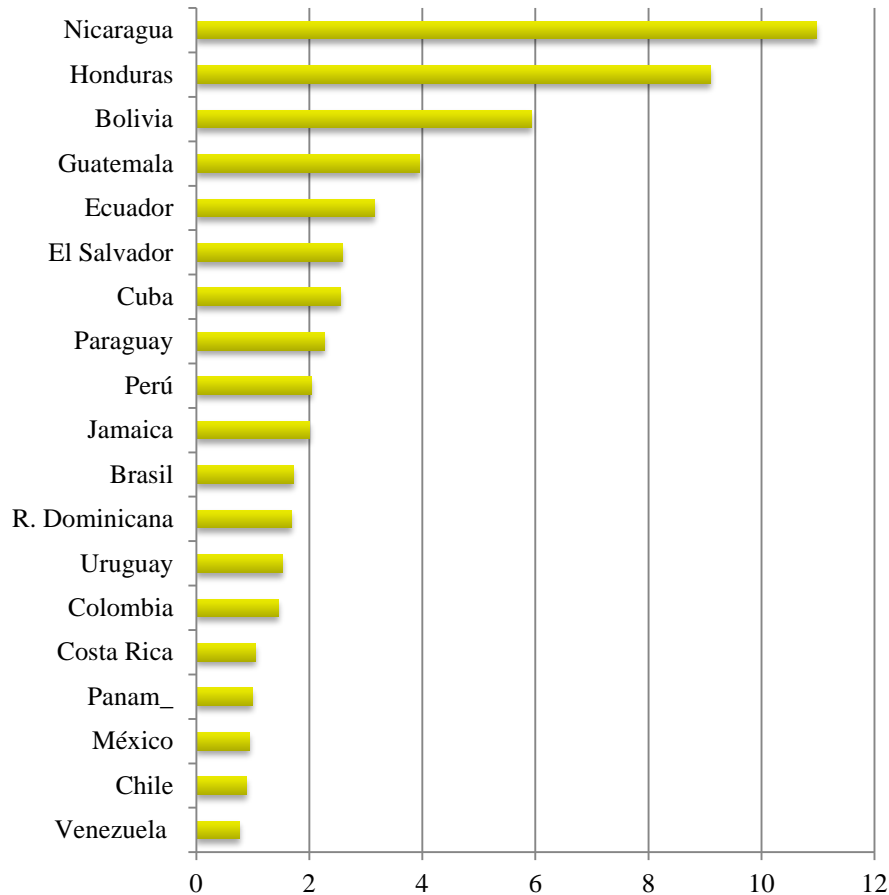
- Boom in capital inflows and non tradable sectors
- Rise in female participation (AR)
- Trade Reform: Ambiguous effects
 - Some in BR, AR?
 - None in [↑]MX, [↓]CO
- Minimum Wages and Labor Regulations (CO, BR)
- SS Reform often lowered Benefit/ Cost ratio
- Legal flexibility and relaxed Enforcement (AR)

Colombia: increase in informality associated to increase in non-wage labor costs and minimum/average wage)

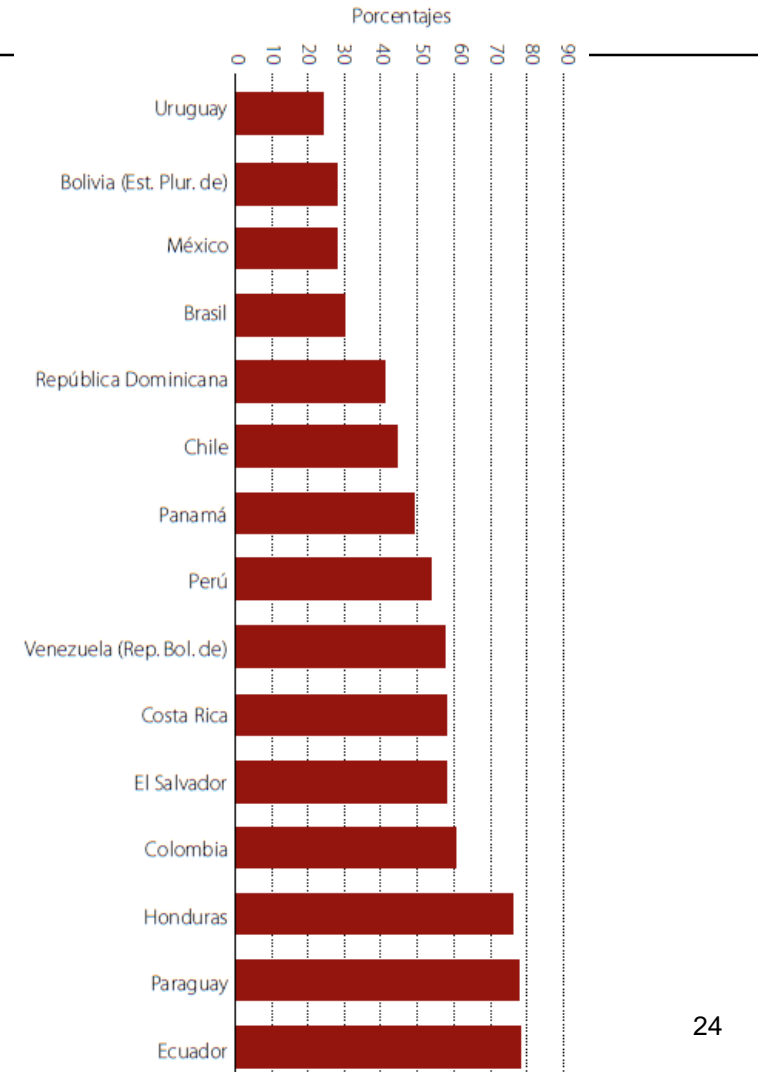


Colombia: High minimum wage

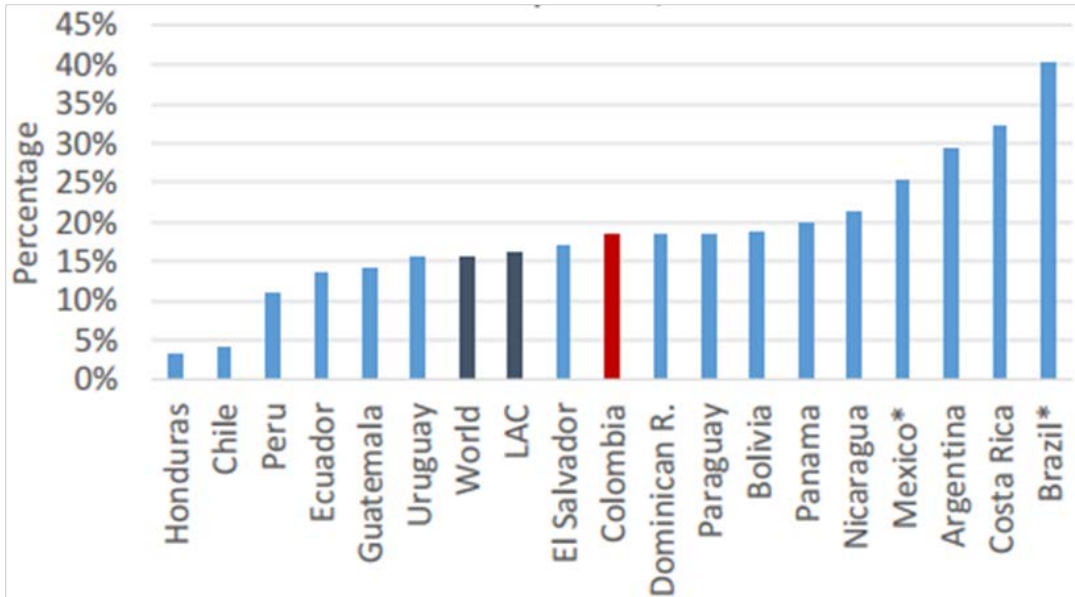
Salario real como % del PIB per cápita (2013)



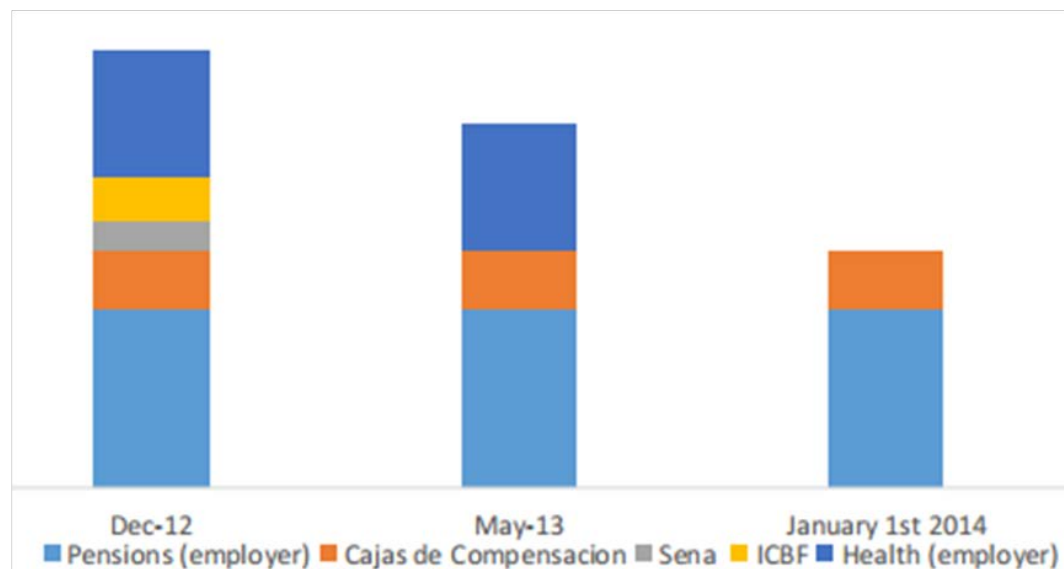
Salario mínimo relativo al salario medio total (2011)



Payroll taxes as percentage of Commercial profits, 2015



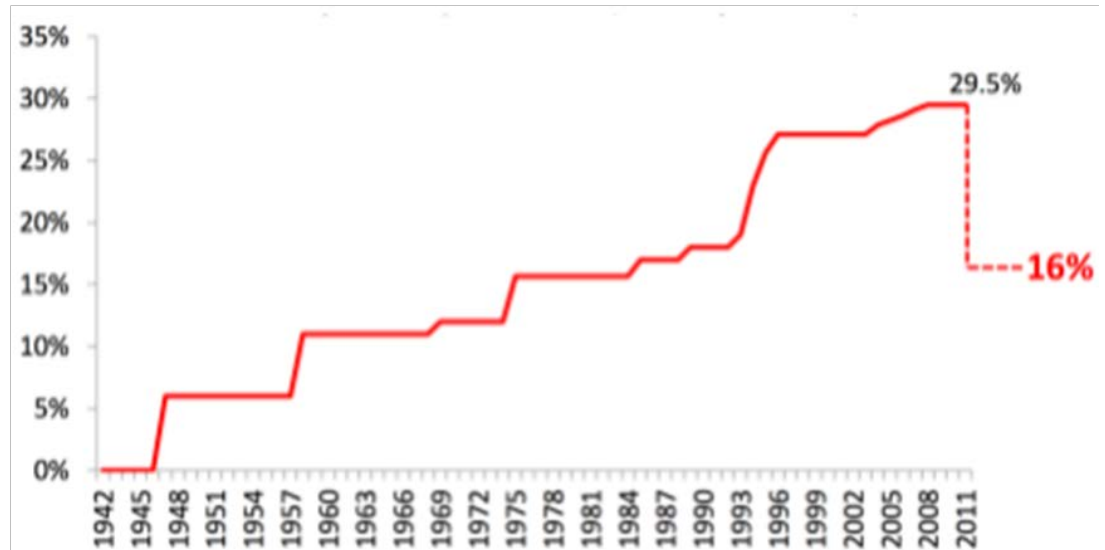
Payroll contributions (employer)



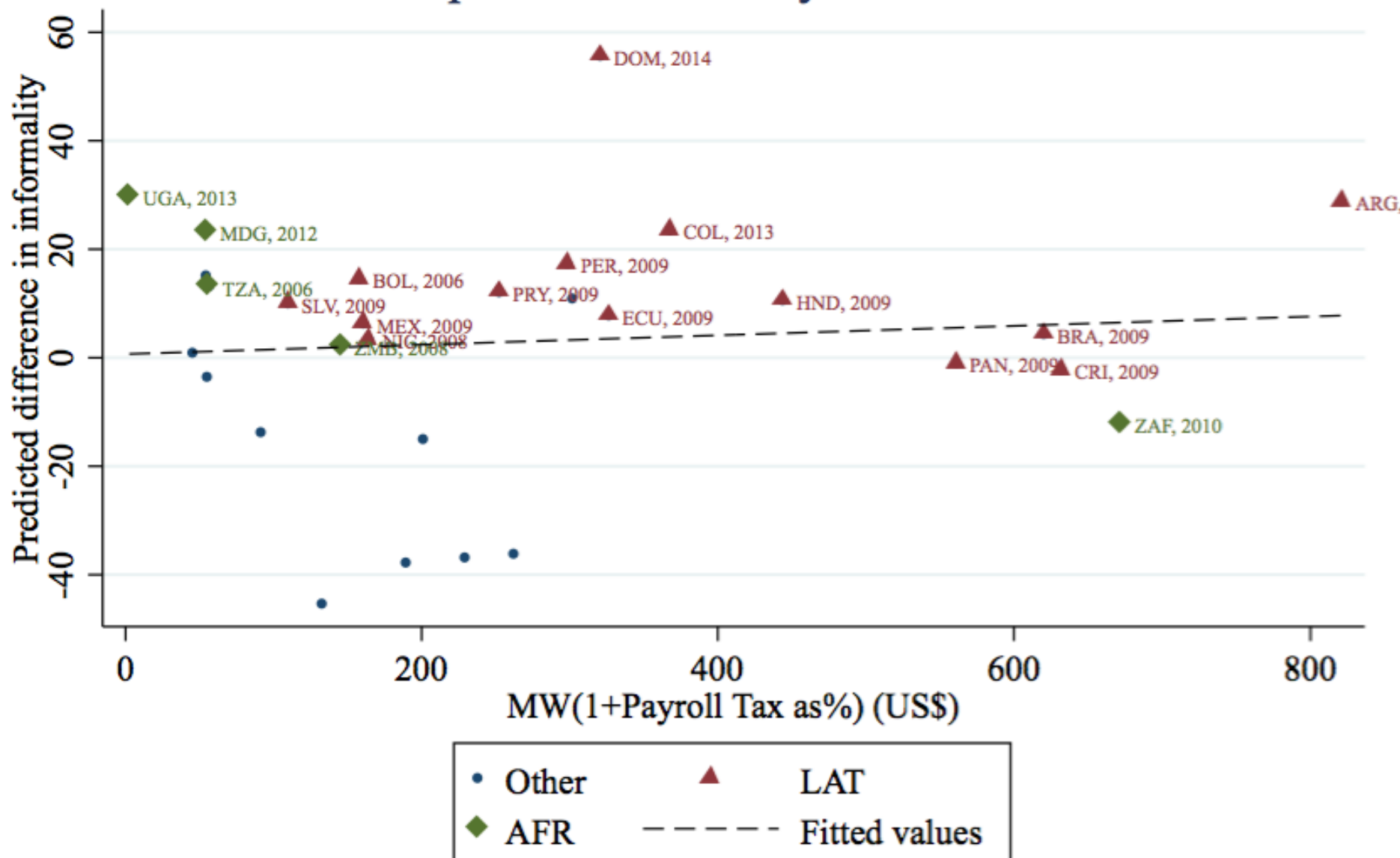
Informality rates: self employment and other employment



Payroll taxes payable by the employer



Difference in Expected Informality vs. Labour Cost Indicator



Source: World Bank (2016); ILO (2016)

Social Protection

Re-engineering the SP system in the face of
Informality

Government failures afflict specific programs and the “system” as a whole

- Weak design of Social Security programs
 - High costs via payroll contributions; rigid one-size-fits-all approach (young vs old; paying twice for health insurance)
 - Excessive “bundling” of benefits (health, pensions, etc., but also housing, childcare, sports & recreation) tax contributors
 - Weak accounting for labor mobility (too-high vesting periods for pensions, intermittent coverage in health)
 - Low quality of services/benefits
- Lack of Incentive Compatibility within the “System”
 - Free assistance programs increasingly “compete” with Social Security creating incentives for informality (eg, Mexico and Colombia health insurance for informal workers)

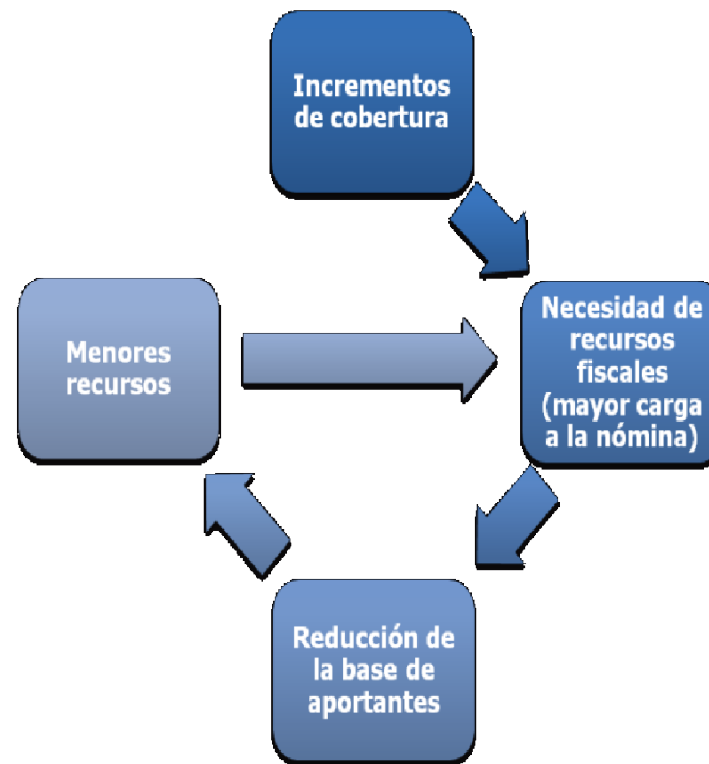


The way forward

- Long-term goals
 - Universal “essential cover” in health financed by general taxation
 - Poverty prevention pensions, targeted to the poor, and incentive compatible with multi-pillar systems
 - Unbundling of ancillary benefits
 - Facilitate mobility between formal and informal sectors
- Getting from here to there
 - Gradual reforms, shaped by initial conditions, labor market structure, and fiscal constraints, focused on
 - Raising the net benefits of social security (unbundling, greater flexibility, higher quality, portability)
 - Strengthening incentive compatibility of the overall “system”

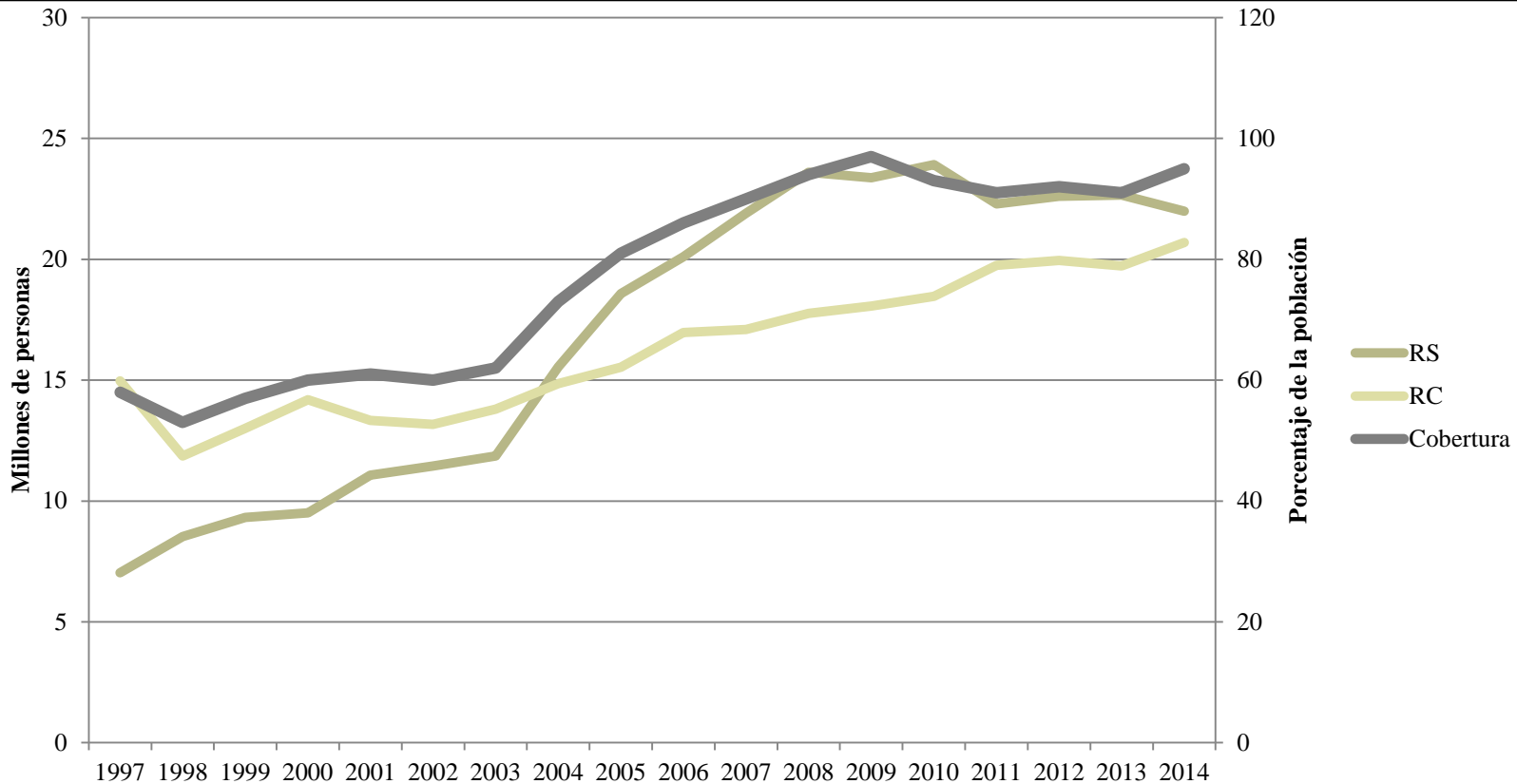
Colombia: a vicious circle of health insurance financing and informality (under 2012)

Figura 1. La financiación de la política social a través de cargas a la nómina conlleva al "círculo vicioso de la informalidad"



Fuente: Santa María et al., 2008.

The effects on health insurance financing



Fuente: Santa María et al. (2011), actualizaciones a partir de información del Ministerio de Salud y Protección Social

Informality and the Social Contract

A socio/economic general equilibrium issue in which “social norms” play a major role

High informality is part of a bad social equilibrium

- Informality : reflection of deeper fractures in the relationship between the state and the citizens, and among citizens. A social equilibrium that does not work for all.
- In a conceptual simplification (**multiple dynamic equilibriums**)
 - an economy may show good governance, trust in the state, high tax compliance, efficient regulation , high productivity growth and fast reduction of informality.
 - or it may show low government effectiveness, inefficient regulation, low trust, evasion, low productivity growth and slow reduction of informality
- **Low quality institutions and poor governance** increase informality:
 - Increase costs and reduce benefits of formality
 - Shape citizens' perception about the effectiveness and fairness of state. **Low trust fosters social norm not conducive to comply with taxes and regulations.**
 - Under weak reciprocity: **people are less willing to comply if others are (perceived) as not contributing their share.**
- **Low tax morale** (and inefficiencies in tax system) **generate low tax** (and regulatory) **compliance. Informality limits then the action of the state and reinforces feedback loop.**

Towards an inclusive Social Contract

- Latin America is heterogeneous:
 - Some countries advancing towards building an effective Social Contract? (eg, Chile since return of democracy - informality falling)
 - Some have had a truncated welfare state that covers part of the population but not yet building an efficient social contract: informality increasing (eg, AR?)
 - Some states are highly captured, taxes are low, presence of the state is very small: informality rampant (GT?)

- Moving towards an inclusive social contract
 - Small changes may lead to a large change (if social norms and perceptions about the State change)
 - Partial reforms may be important steps, if part of a longer term view.