Informality: Exit and Exclusion
Main conclusions and policy messages

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Informality is both a consequence and a cause of underdevelopment. Under development explains almost 80% of informality.

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
Informality is reduced with firm growth

Effects of doubling in size of SME’s

Fuente: Perry et al. (2007)
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
Why firms choose to formalize

Advantages of formalization reported by IFC-surveyed firms

Avoid paying fines
Compliance with the law
Avoid paying bribes
Gain new clients
Improved access to credit
Operation on a greater scale
Legal power to demand contracts is upheld

Mean of firms with no employees
Mean of firms with at least one employee

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

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
### 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)

Cunningham (2006)
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

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

Mexico: Job Finding Rates: Transitions from U to Work
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

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Colombia: High minimum wage

Salario real como % del PIB per cápita (2013)

Fuente: OIT (2014) Incumplimiento con el salario mínimo en América Latina-
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

MW(1+Payroll Tax as%) (US$)

Predicted difference in informality

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.