

Exit and Exclusion as Routes to Informality

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Informality is a way of life in Latin America and the Caribbean—indeed, in much of the developing world. In most countries of the region, many workers are not covered by labor protections, the microenterprises found on every street corner often are not registered with authorities and comply only partially with other regulations, and tax evasion is the norm among rich and poor alike.

These features of the Latin American landscape are not new. But the striking increase in their incidence in some countries in the 1990s has given new life to the debate about what high levels of informality tell us about how economies are functioning—and about what we can do to overcome that informality.

A new report by a World Bank team, *Informality: Exit and Exclusion*, explores the richly varied informal sector from a range of perspectives—from the protection of workers and the productivity of firms to the determinants of tax evasion. Much informality has to do with exclusion—with citizens being left outside formal institutions. But exit also plays an important part: many workers, firms, and families, dissatisfied with the performance of the state or simply finding no benefit to interacting with it, opt voluntarily into informality.

The gross flows of workers between the formal and informal sectors often mimic search behavior found in the job-to-job flows in the United States: they are procyclical and broadly sym-

metric. This suggests that entry into the informal sector is often voluntary, a finding confirmed by novel survey data on sectoral choice decisions.

Broadly, informal workers form two clearly distinct groups. The informal self-employed (including owners of microenterprises) are largely voluntary, older workers, while the informal wage earners tend to be young workers searching for better jobs, either formal salaried jobs or self-employment. But the report also finds much heterogeneity within these groups and across countries.

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Informal micro firms exhibit dynamics similar to those of small firms in the industrial world. The small steady-state firm size often means little demand for services associated with formalization (such as support programs for micro and small firms and access to financial and judicial services).

Measures to lower the costs of formality therefore yield effects that, while positive, are often modest. A more holistic approach is recommended, one that would also improve the benefits of formality and increase the opportunity cost of remaining informal. Firm-level analysis identifies several plausible channels through which informality may affect overall productivity, but cross-country panel analysis is unable to identify robust aggregate impacts on growth.

Poorly designed social security systems, and alternative free services for the informal, create both a push and a pull toward the informal sector. The report speculates on the link between informality and the soundness of the “social contract”—a shorthand for how citizens of the region relate to the state and to one another. It suggests that high informality indicates serious

institutional failures that lead to, and are reinforced by, generalized social norms of noncompliance with regulations and tax obligations.

Unsurprisingly, the report’s analysis gives rise to recommendations spanning the policy agenda. Since the high level of informality in developing countries is due largely to the low opportunity cost of opening a micro business, the gamut of measures to increase formal sector productivity—improving the business climate, fostering innovation, and the like—and improve workers’ skills is important.

Labor market reform continues to be key, since part of the growth in the share of workers not covered by labor protections in Latin America in the 1990s appears to be due to the increased burden of labor costs and restrictions in several countries. But reform also needs to extend to remedying the poor design of the social protection system, which creates incentives favoring informality.

More generally, shifting the cost-benefit analysis of workers toward engaging with the institutions of the state—both by increasing the benefits of formality and by improving monitoring—is critical to reducing their often voluntary entry into informality. The experiments in reducing the costs of registering businesses and simplifying and reducing taxes for small firms have led to a modest formalization of existing businesses, though with potentially important impacts on these firms. Progress in this area therefore continues to be important and should be complemented with policies that could enhance the access to and quality of services associated with formalization.

All these reforms need to take place in a context of improving the efficiency and fairness of the state, which is often perceived as ineffective and serving only the needs of elites. In the long run this is the only way to change social norms of noncompliance and reduce the “culture of informality.”

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