OVERVIEW

Informality: Exit and Exclusion

There are two main types of activist reactions to discontent with organizations to which one belongs or with which one does business: either to voice one's complaints, while continuing as a member or customer, in the hope of improving matters; or to exit from the organization, to take one's business elsewhere. —Albert O. Hirschman (1981, p. 246)

Informality has gained increasing attention as a possible drag on growth and rising social well being, and as a force corrosive to the integrity of our societies. In fact, informality is not especially higher in Latin America and the Caribbean than in other developing countries of similar per capita income, according to two popular measures (figure 1). However, given the long-standing negative connotations of informality—inferior working conditions, low-productivity firms, disrespect for the rule of law, to name a few—it is not surprising that the rise in informality over the 1990s across several measures (figure 2) is viewed with concern and as meriting closer investigation.

This said, the mere fact that we need to employ multiple measures of informality capturing distinct approaches to the sector suggests that we are not clear on exactly what it is and what we should be studying. In all likelihood, we are dealing with several distinct phenomena under this convenient, but arguably unhelpful, umbrella term. For a report on informality in Latin America and the Caribbean this clearly poses special challenges. Fortunately, recently available data sets and the development of new techniques to analyze them have made possible more solidly grounded analysis of the underlying heterogeneity and reasons for being of the sector, the factors driving its evolution across different countries, and its social and economic ramifications. Such an analysis, we hope, will serve as a foundation for more effective public policies.

The razón de ser of the informal sector: Adding exit to exclusion

The report sees informality as a manifestation of the relationships between economic agents and a state that the economic literature should play an important role in remediing market failures, coordinating the provision of public goods, and maintaining a level and equitable playing field. Of the many lenses through which informal workers have been viewed, the most influential lens has focused on their exclusion from critical state benefits or the circuits of the modern economy. This exclusion can be seen as occurring along three margins, or borders, between formality and informality. First, a long tradition in the labor literature sees segmentation in the labor market as preventing workers from leaving their holding pattern in informality and taking jobs in the formal sector that offer state-mandated benefits. Second, de Soto’s (1989) seminal work argues that burdensome entry regulations prohibit small firms from crossing the line into formality and thriving. And, third, some larger firms faced with excessive tax and regulatory burdens may remain partially informal as a defensive measure and, as a result, they forgo potential growth and efficiency gains. This report finds that these exclusion factors
are indeed important, documents their negative impact on productivity and welfare, and discusses some of the reforms necessary to mitigate them.

However, the report also highlights a second lens through which to view informality. This lens is more akin to Hirschman’s (1970) exit: many workers, firms, and families choose their optimal level of engagement with the mandates and institutions of the state, depending on their valuation of the net benefits associated with formality and the state’s enforcement effort and capability. That is, they make implicit cost–benefit analyses about whether to cross the relevant margin into formality, and frequently decide against it. This view suggests that high informality results from a massive opting out of formal institutions by firms and individuals, and implies a blunt societal indictment of the quality of the state’s service provision and its enforcement capability.

This view leads to important divergences with many popular stylized facts about the informal sector. Microfirm owners with little intention or potential to grow may see insignificant benefits from engaging with unhelpful regulatory and tax institutions. Interpreting Hirschman literally, they take their business elsewhere, knowing that they will fall below the radar screen of enforcing authorities. Unskilled workers, who partially pay for social protection benefits directly and implicitly through lower formal wages, may find that what they expect to get in the formal jobs for which they are qualified does not outweigh the forgone current consumption or the greater flexibility and earnings they may get as informal workers. This is especially true when they have social protection alternatives through access to universal or noncontributory programs, or through private means. Larger firms or skilled professionals may decide to underreport their operations and incomes, balancing private gains from tax evasion with lower detection risks resulting from poor enforcement.

These two lenses, focusing, respectively, on informality driven by exclusion from state benefits and on voluntary exit decisions resulting from private cost–benefit calculations, are complementary rather than competing analytical frameworks. First, individual countries differ greatly in history, institutions, and legal frameworks, so exclusionary mechanisms may be more important in some and exit may be more important in others. Second, the informal sector is tremendously heterogeneous, and arguably, then, there is a continuum in the relative importance of exclusion and exit among individual workers and firms within countries. Third, in some cases the two can be virtually indistinguishable. A microentrepreneur concluding, through a cost–benefit analysis, that formality is not worth the high registration costs may be explicitly excluded or self-excluded—either way, the effect is much the same. A poor worker, excluded...
from health care services because he or she lives in a remote rural area or a poor urban neighborhood, may see little point in being formal and paying labor taxes for services to which he or she has no access.

Finally, informality is a multidimensional phenomenon: agents interact with the state along some dimensions and not others, creating a large gray area between the extremes of full compliance and noncompliance. Exit and exclusion can play different roles across different dimensions: a microfirm owner unlicensed because of high registration costs may be de facto excluded from desired formal credit circuits while opting out of contributing to poorly designed state pension funds on behalf of his or her workers. The findings of the report indeed support the use of both lenses to fully understand and address the causes and consequences of informality in the Latin American and Caribbean region.

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**FIGURE 2**

**Trends in informality, by various definitions**

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**Informal workers: Productive definition (%) of employed workers**

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**Informal salaried workers: Legalistic definition (%) of salaried workers**

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Note: Although global data is available only for the definitions of informality as self-employed workers and workers not covered by a pension scheme, two other measures are calculated here based on regional data sources. In the “productive” definition, a worker is considered informal if he or she is unskilled self-employed, a salaried worker in a small firm, or a zero-income worker. In the “legalistic” definition, a salaried worker is informal if he or she does not have the right to a pension linked to employment upon retirement.

a. Percent of workers without carteira (work card).

b. Based on the balanced panel sample (common municipalities) for the period 1990–2004.
Workers: A mix of opting out and exclusion

This report examines informal labor using the vast set of regular household surveys conducted in most countries of the region, together with recent special modules on informality collected by statistical agencies in Argentina, Bolivia, Colombia, and the Dominican Republic, in collaboration with the World Bank and line ministries. The analyses shed light on the characteristics of informal workers, their motivations, and their preference for the benefits and nonpecuniary characteristics of jobs (for example, flexibility, autonomy, stability, mobility) by examining their remuneration, self-rated welfare, and job satisfaction. The findings (summarized in box 1) show great heterogeneity within and across countries. They also indicate, however, that the informal sector can generally be thought of as comprising two large groups who differ significantly in both their motivations and their relative levels of job satisfaction.

First, on average, independent workers—the self-employed or those owning microfirms—in the countries surveyed (with the exception of Colombia) report being as well-off as they would be in jobs they are qualified for in the formal sector. As a consequence, the majority are not looking for formal jobs. Most of these informal workers appear to choose their occupations according to their individual needs (especially their desire for flexibility and autonomy) and abilities (their comparative advantage in terms of entrepreneurship). In fact, when asked, a majority of workers state that they prefer the independence of being self-employed. In Mexico, they were overachievers in salaried work, earning relatively high wages, given their human capital. Many women, in particular, report foregoing

Box 1

Informal workers in Latin America and the Caribbean: Their profile, motivations, earnings, and welfare

Who are the informal?

Informal employment encompasses a diverse range of people. While the report considers numerous common criteria to define informal employment, it focuses on the social protection definition. Based on whether the job is a salaried relationship and unregistered with social security, informal employment accounts for 54 percent of total regional urban employment and it comprises two groups: (1) informal independent workers, making up 24 percent of total urban employment (ranging from 20 percent or less in Argentina, Brazil, Chile, and Uruguay to more than 35 percent in Bolivia, Colombia, the Dominican Republic, Peru, and the República Bolivariana de Venezuela), and (2) informal salaried workers who account for roughly 30 percent of total regional urban employment and more than half of all informal work (ranging again from 17 percent in Chile to more than 40 percent in Bolivia, Ecuador, Guatemala, Mexico, Nicaragua, Paraguay, and Peru) (figure 1.B.1).

The informal independent work sector includes microfirm owners and self-employed professionals, as well as artisans, handymen, construction laborers, taxi drivers, and street vendors. The informal salaried work sector largely comprises domestic employees, unpaid family

Source: Author’s estimates, based on household surveys. Note: In Ecuador, Mexico, and República Bolivariana de Venezuela, coverage of independent workers is proxied by having a tertiary education. Argentina denotes Greater Buenos Aires.
workers, microfirm workers, and those who work in larger firms under informal labor arrangements. The characteristics more strongly correlated with informal employment are firm size (10 employees or fewer), education (completion of schooling below the secondary level), industry sector (construction, agriculture, retail, and transport), tenure (less than one year), age (youth predominantly informal salaried, self-employed mostly older workers), and women’s household status (married women with children).

**What are their motivations, earnings, and welfare?**

Evidence from workers’ patterns of mobility, reported motivations, and self-rated welfare and job satisfaction indicate that (1) the majority of independent workers (approximately two-thirds) entered their jobs voluntarily, attach significant value to the nonpecuniary benefits of autonomous work, and choose to “exit” formal social protection systems; (2) on the contrary, the majority of informal salaried workers appear to be excluded from more desirable jobs, both as formal salaried and as independent workers, although voluntary motives are still significant for many of the people in this subsector (for example, youth and unpaid family workers). Informal workers state they do not contribute to social security and health insurance plans mainly because of low incomes and also because of their employer’s decision not to offer benefits (in the case of most informal salaried workers); because they lack information on the benefits and functioning of social protection programs; and, in the case of health care, because they resort to other means of coverage, including coverage through other family members and universal services.

For both groups of informal workers, there is substantial heterogeneity of motives and demographic characteristics. For instance, in Argentina, the informal self-employed report being as well-off as formal salaried workers, but the informal salaried appear worse-off (figure 1.B.2); in the Dominican Republic, both informal self-employed and in-formal salaried workers are as well-off as formal employees (figure 1.B.2); and, in Colombia, both informal groups report much lower levels of satisfaction with current jobs.

**FIGURE 1. B.2**

**Impact of informality on self-rated poverty**

![Graph showing the impact of informality on self-rated poverty in Argentina and Dominican Republic.](lacf_001-020.qxd  5/9/07  4:20 AM  Page 5)

**Source:** Arias and Luchetti (2007), based on household surveys, 1997 and 2004.

**Note:** Self-rated poverty is based on household survey responses.
formal salaried work to better balance home and work responsibilities.

Moreover, even though the desired flexibility associated with self-employment and microfirm ownership is often associated with low income and little security, those jobs are still considered better options than the corresponding jobs that the workers could get in the formal economy, given their minimal human capital, access to other assets, and the low aggregate productivity in the economy. In other words, many self-employed workers opt for informality because their options in the formal sector are at least equally poor. Furthermore, they have the possibility of using informal mechanisms or freely available (noncontributory) social protection programs to substitute, in part, for formal social security benefits that they would otherwise have to pay for, explicitly or implicitly, via (sometimes steep) payroll taxes. In summary, most of the self-employed do not appear to be "excluded" from the formal sector; rather, after implicitly making a cost–benefit analysis, they opt out of formality.

A different picture emerges, however, for the majority of informal salaried workers in the countries studied. Indeed, most of the informal salaried appear to be queuing for more desirable jobs in either the formal salaried sector or as self-employed workers (with Mexico and the Dominican Republic being notable exceptions). For many of these workers, informality largely reflects the decision of the firms for which they work, especially microenterprises, to operate outside the realm of government regulations. On average, these workers are not choosing to opt out of formal contracts and social security institutions, and they would much prefer an equivalent job in the formal sector. In these cases, exclusion rather than exit from formality appears to be the driving force behind their present informal status.

However, considerable heterogeneity exists even within these two subsectors of the informal sector, with both voluntary and involuntary entrants and a great variety of workers’ life trajectories found in each. For example, while, on average, salaried workers in microenterprises appear to want a formal sector job or self-employment, approximately half of the employees of Mexican microenterprises turn out to be unpaid family members whose presence in the sector probably reflects a mix of professional and personal considerations. Similarly, while, on average, independent workers are as well-off as their formal counterparts, about one-third of the self-employed (over half in Colombia) appear to be so largely involuntarily; they would prefer formal jobs.

There is also considerable variation across countries in the plausible causes of job segmentation for those groups of informal workers who report being involuntary. For example, in Brazil, Colombia, and Peru, the evidence points to an impact of increasing labor costs and rigidities on the expansion of informality in the 1990s. In other countries, such as Argentina, the introduction of temporary contracts and subsequent weakened enforcement of tax and labor regulations seem to have played a role in the observed increases in the share of the labor force without social security contributions. In most countries, trade liberalization appears to have had modest or no effects on informality trends.

The presence of both exit and exclusion factors in informal labor markets—apparent in informal workers’ subjective motivational responses and self-rated welfare measures reported above—is corroborated by the observed patterns of labor market dynamics, an important analytical tool introduced in this report. Indeed, evidence from Mexico (figure 3), suggests that, during good times, the number of workers who leave the formal sector to become self-employed or take an informal salaried job is nearly equal to or sometimes even greater than the number of those who transit from the informal to the formal sector. This is a major piece of evidence supporting the view of integrated labor markets in which workers are freely choosing between formal and informal jobs.

![FIGURE 3](lacf_001-020.qxd 5/9/07 4:20 AM Page 6)
However, although initially following a pattern similar to that of Mexico, after the constitutional reform in Brazil the flows from informal to formal salaried employment became significantly lower than the flows in the reverse direction even in boom times—suggesting a significant degree of market segmentation. Consistent with the literature focused on the U.S. economy, it is also true that formal sector hiring comes almost to a halt during bad times, perhaps reflecting more binding downward wage rigidities. Hence, many entrants have no choice but to join less desirable occupations in the informal sector. As a consequence, the performance of labor markets is asymmetric throughout the business cycles in most countries: labor markets tend to behave more as segmented markets during downturns and recessions, and more as integrated markets during booms.

Finally, both the more exclusionary and exit dimensions of informal salaried work are suggested by workers’ lifecycle employment trajectories. In most countries, young workers, especially the less educated, are more likely to be informal employees than formal salaried workers, and very few are informal self-employed. Meanwhile, middle-aged and older workers are more likely to be found in the formal sector or to be self-employed, although many still end up as informal employees (see figure 4). This suggests that informal salaried work is a point of entry to the labor market for many of the young, and, as they accumulate experience or simply queue, they are more able to find a job in the formal sector or fulfill a surprisingly common desire to be self-employed. Informal salaried employment is also an option for many older workers who lack the skills or capital to become self-employed or get a formal salaried job, or who opt out of informality because, for example, they will never accumulate enough years to secure a meaningful pension. The fact that participation in self-employment rises with age is, again, similar to that of the United States, and similarly may be partly explained by voluntary entry delayed by credit or human capital constraints.

The findings discussed above have critical implications for policy design. Whether because of outright exclusion and market segmentation or massive voluntary opting out of formality, informality may lead to a suboptimal social equilibrium in which many workers go unprotected from health and employment shocks and from poverty in old age. In either case, the imperative for reform is strong. However, our findings caution against one-size-fits-all solutions. Again, whereas labor markets in Mexico and the Dominican Republic show a high degree of integration—for example, most informal workers choose to be informal—except, perhaps during crises—labor markets in Argentina, Colombia, and, to a lesser extent, Brazil show many signs of segmentation. Thus, it is very useful to clarify the relative importance of alternative drivers of informality so that strategists may devise the most suitable policy changes.

For example, if labor informality were essentially driven by inadequate labor legislation leading to labor market segmentation, then the key to reducing informality would be to engage in (politically demanding) labor market reform. If, however, expected low benefits and high costs of social security contributions relative to other forms of protection against shocks are prominent in driving many workers to opt for informality, reform of the design and provision of social protection benefits must be an additional component of the policy package to reduce informality. Indeed, this report finds that there is significant room for improvements in the area of social protection program design (box 2). Further, when considering the case of informal salaried workers, it is also key to understand and address the factors that lead firms to be partially or entirely informal, as we discuss in the next section.
INFORMALITY

There are high human costs associated with the lack of access to appropriate risk management instruments, such as health insurance and old-age security. In addition, missing insurance markets and other market failures—such as negative externalities associated with the absence of health treatment or unsupported poor elders—create a clear rationale for public intervention to ensure basic access to social protection. Therefore, a key challenge facing policy makers in Latin American and Caribbean countries is to ensure that their citizens have suitable access to social risk management instruments, even in the face of significant informality in the region. However, ill-designed interventions actually may serve to make things worse. They not only hinder people's ability to access basic services or to manage risk, but also distort economic incentives that may have adverse effects on productivity and long-term economic growth, for example, by creating strong incentives for many workers to remain informal.

Indeed, in Latin America and the Caribbean there is ample evidence of “government failure” in the design and implementation of social protection, and that failure needs to be addressed as part of any actions to strengthen risk management among the region’s citizenry. This report documents these issues in detail. At the level of specific programs, design problems raise the costs of participating in social security, relative to the benefits of participation, causing some workers to opt out of the system. Design deficiencies also impede some workers’ access to benefits. At the level of social protection systems—the constellation of contributory social security and noncontributory social assistance schemes—programs often compete, creating adverse labor market incentives and outcomes.

Among the key weaknesses in the design of the region’s social security programs we find the following:

- High payroll contributions relative to the expected benefits and quality of service: Evidence shows that high contributions can act as a disincentive to formal employment.
- Excessive “bundling” of multiple benefit packages: For example, packages in some countries include not only health care, worker risk, life insurance, and pensions, but also housing, child care, and sports and recreation. Some of these components represent “pure taxes” rather than contributions that give rise to benefits for many formal sector (or potential formal sector) workers.
- Rigid, one-size-fits-all approaches to mandated social security programs: For example, spouses and secondary household workers who opt to enter formal employment generally would have to pay for health coverage to which they already have a right through the household head’s affiliation. This double payment for a single benefit creates a powerful incentive to choose informal jobs. Furthermore, social security systems rarely account for different needs and preferences among workers at different stages of the life cycle, and, as a consequence, high initial payroll contributions create a significant disincentive for young workers who have other investment priorities (such as education and housing) to join the formal sector.

- Weak accounting for workers’ mobility into and out of the formal sector during their careers and across their life cycles: In particular, lengthy pension vesting periods make many workers ineligible because of the high mobility between formal and informal sectors, and thus creates, ex ante, a major disincentive to choosing formal jobs. Furthermore, lack of portability often leads to intermittent health insurance coverage gaps for workers who shift from formality to informality and vice versa.

Moreover, recent efforts of a number of governments in the region to use noncontributory or subsidized assistance programs to compensate for low social security coverage inadvertently may have complicated the quest to provide effective social protection to a broader swath of the region’s population. Indeed, the evidence suggests that programs offering informal workers services on a noncontributory or highly subsidized basis actually may “compete” with formal social security programs that workers have to pay for through payroll tax contributions, thereby creating additional incentives for informality.

Addressing these design weaknesses will be important not only to ensure broader access to effective risk management instruments by the citizens of Latin America and the Caribbean, but also to make social protection programs consistent with increased productivity and sustained economic growth in the future.
Firms: Little gain, high costs, or weak enforcement?

Labor informality is primarily a small firm phenomenon with the vast majority of workers who are unregistered with social security administrations found in firms of fewer than five workers (figure 5). Hence, understanding the rationale behind small firms’ decisions to register their firms and their workers, to pay taxes, and so forth is fundamental to understanding the phenomenon of informality.

The report shows that, in nature and dynamics, these microfirms are closely related to their advanced-country counterparts and should not be treated as a pathology peculiar to developing countries. As figure 6 shows, the patterns of entry, exit, and participation in self-employment are very similar, suggesting that the high levels of self-employment seen in figure 1 may not reflect a fundamentally different phenomenon but simply much more of it. This may arise precisely because the lower labor productivity of the formal sector in developing countries implies a lower opportunity cost of participating in independent work, which worker surveys suggest is as highly regarded in Latin America and the Caribbean as it is in countries of the Organisation for Economic Co-operation and Development (OECD).

In this light, although a sizable body of literature sees these firms’ lack of registration with the authorities through an exclusionary lens, this report argues that formality can be seen as an input in the production process for which small firms have little need. Formality increases rapidly with firm size and productivity. As an example, whereas 86 percent of Mexican microfirms with only one paid employee do not pay social security contributions, 71 percent of those with five paid workers report paying social security for at least some of their employees. In Brazil, 76 percent of microfirms do not have an operating license and 94 percent do not pay taxes. Those rates fall to 33 and 23 percent, respectively, among firms with five paid workers.

However, the large majority of microfirms remain too small to benefit sufficiently from formality to overcome its various costs. In Brazil, for instance, 87 percent of all microfirms have no paid employees. In Nicaragua, less than 7 percent of microfirms have more than two employees after three years of operation. Most of these firms have no potential to grow (turnover is extremely high in this sub-sector), and thus their credit needs may be marginal. They have a limited number of clients and with most of those clients they have personal relationships, so they would not benefit much from greater access to the organized impersonal markets and courts usually associated with formality.

It is not surprising that a survey of informal Mexican microfirms reveals that nearly 75 percent of the microfirms report the main reason for not registering with the authorities is that they are just too small to make it worth their

![FIGURE 5 Informal workers across firm size](image-url)
while. In contrast, only 2, 8, and 4 percent of surveyed firms, respectively, answer that the main reason is the high costs and time required to register or the high costs of operating as registered businesses. The same appears true in the Dominican Republic, although prohibitive registration red tape seems to be of greater import in Argentina. In most cases, the degree of formality increases with firm size, suggesting that as firms grow, their demand for the services associated with formal institutions increases, as does the probability of detection by authorities.

Having so much of the workforce in microfirms and having so many of these microfirms unplugged from the formal economy in all likelihood extract some productivity costs. First, there may be scale economies or externalities arising from employment in large firms. To the extent that informality is associated with a preponderance of small firms and that increasing returns to scale are relevant for their size range, informality could lead to considerable efficiency losses. Second, unfair competition from informal firms could slow down the process of creative destruction by which inefficient firms are replaced by their more efficient competitors, and could negatively affect the incentives of formal firms to innovate and adopt new technologies. Third, if reducing the costs and increasing the benefits of formality allow previously informal firms to gain increased access to markets and services, the result could be increased aggregate productivity growth.

The firm-level evidence reported here presents a mixed record on the above hypotheses. The microfirm evidence suggests that firms choosing to register do have better performance or, alternatively, the firms that started operations being registered exhibit, on average, higher levels of labor productivity than their equivalent unregistered peers. In particular, programs in Brazil and Mexico to reduce the costs of becoming formal have had a positive impact on the performance of those firms that decided to cross the frontier from informality to formality. The evidence on the effect of these programs on the aggregate levels of informality and productivity through time remains inconclusive (as will be discussed in chapter 6). Further, evidence from the investment climate reports suggests that firms surrounded by complying firms have higher rates of productivity. However, there is evidence that, in some cases, informality reflects defensive evasion of possibly excessive regulation.

All evidence considered, the report concludes that tilting the cost–benefit analysis toward formality for a substantial percentage of informal firms requires a fair combination of “carrots” and “sticks.” As an example, in Brazil and Mexico, microfirms constrained at the frontier coexist with entrepreneurs who show no demand for the presumed benefits of formality and for whom reducing registration costs would not lead to formalization under present conditions. Similarly, evidence for the Dominican Republic suggests that many informal firms perceived more gains from
staying under the state radar, including not only the tax savings but also the avoidance of interaction with the state bureaucracy altogether. Further, a large fraction of firms that become formal allegedly do so to avoid fines and bribes, according to surveys of many countries in the region (see figure 7). Thus, interventions to address regulatory constraints faced by small firms or to reduce tax rates might not be enough to achieve a major change in their levels of formality. Such a goal would also require improving the positive incentives for joining the formal sector, including improvements in private and public services available to formal firms (for example, credit, contract enforcement, technical assistance, and the like), and enhancing the level of enforcement to increase the opportunity cost of remaining informal.

Nonetheless, the low aggregate productivity in the formal sector would put some limits on the overall effect of even well-designed, integrated programs to induce informal firms to become formal. Hence, a large chunk of the efforts to reduce informality must focus on policies to enhance productivity and growth in the formal sector, which would increase the perceived benefits of formality, along with the opportunity cost of remaining informal.

Finally, in many countries in the region, even large firms show considerable tax evasion and labor informality. They have a significant number of employees without social security contributions, and the fraction of underreported sales for tax purposes is quite high—even as high as in small firms, in some cases (see figure 8). Firms again appear to undertake a careful cost–benefit analysis, weighing the “private” benefits
of informality (evading taxes, avoiding burdensome regulations) against the “private” costs of informality (risk of penalties and bribes, imperfect access to markets and government services) in choosing their “degree” of formality. Administrative and tax simplification programs to reduce red tape and compliance costs, regulatory reviews aimed at eliminating laws and regulations that are either anachronistic or privately motivated, and enhanced enforcement are the key policy responses with respect to the phenomenon of partial informality within large firms.

**Need for more effective and legitimate institutions**

Whether informality is an outcome of exclusionary policies or mechanisms, or a result of cost–benefit decisions by firms and individuals that lead them to opt out of formal institutions, it represents a fundamental critique of the Latin American state at several levels. In the burdensome business and labor market regulations, as with the poorly designed social protection systems, the state is complying inadequately with its designated roles. This failure, in conjunction with an abiding lack of confidence in who the state represents and serves and in its capacity to enforce the law, may intensify the tendency of many Latin Americans—perhaps no more or less than citizens of other emerging regions—to opt out, rendering the fulfillment of the fundamental roles of the state all the more difficult.

As an example, most countries in the region are characterized by “truncated welfare systems,” in which those in the formal sector have access to an often generous multidimensional package of social security, while those in the informal sector have much more limited access to government benefits or formal risk management instruments. Not only has overall progress in increasing social security coverage been slow in the region, but coverage has actually declined in a number of countries throughout the 1990s. And, in nearly all countries in the region, coverage rates are significantly lower among low-income than among high-income workers (see figure 9). Indeed, in many countries the poorest workers and families are practically excluded from the system. At the same time, although independent workers can choose to participate in formal social security systems in many countries, very few do it voluntarily. Actually, there is evidence that many workers opt out from the system once they obtain the right to a minimum pension (see Gill, Packard, and Yermo 2004).

The underperformance of Latin American and Caribbean states may reflect deeper, poorly resolved social tensions that may be thought of as constituting a dysfunctional underlying “social contract”; in Hirschman’s terms, the lack of voice and loyalty. Beyond high informality, this can also be seen in the inability of the state to redress the long-standing high inequality, in the weak rule of law, in the sometimes large share of undocumented citizenry, or in the recurrent

![Figure 9](lacf_001-020.qxd 5/9/07 4:20 AM Page 12)
bullets of macroeconomic instability. For example, high inequality of incomes and power is correlated with informality (see figure 10) and is often associated with weak institutions and state capture by both elites and organized segments of the middle class (see de Ferranti et al. 2004; Perry et al. 2006). State capture leads to the generalized perception that the state is run for the benefit of the few, and thus it reinforces a social norm of noncompliance with taxes and regulations, what might be dubbed a “culture of informality.” Noncompliance is then further compounded by the suspicion that others are not complying either—an absence of what is termed “strong reciprocity—which, in turn, makes enforcement even more difficult.” As an example, in the Dominican Republic, 19 percent of small firm owners report that they do not register or contribute to pension systems because “businesses like them don’t.”

At a more aggregate level, after controlling for per capita income, informality is negatively correlated with “tax morale”—society’s disposition toward tax compliance—which, in turn, depends inversely on perceptions of “state capture” (see figure 11) and positively on perceptions of the quality of public spending. Furthermore, informality measured as the share of the workforce in self-employment is negatively related to the quality of institutions, as indicated in figure 12. This suggests that greater exit to independent work accompanies higher distrust of the state. Inequality and its correlates then lead to inefficient laws and regulations (tax privileges and loopholes, weak competition laws, and cumbersome regulations). Those inefficiencies lead to low tax collections and the abuse of monopolistic power, and they further erode state legitimacy and its capacity to provide public goods and services and to enforce the law. Some recent literature has focused on the possibility that Latin America is locked, in fact condemned, to a bad social equilibrium where entrenched elites have no interest in responding to the voiced petitions of those seeking full participation.

However, this report is more optimistic about the possibilities for incremental reform, despite acknowledging the vital importance of enhancing the legitimacy of the state. Ironically, this conclusion partly emerges from the study of the distressing increases in informality in many countries of the region over the 1990s. These increases can be traced partly to sharp increases in real minimum wages in some countries, inadequate macroeconomic policies (that led to artificial booms in nontradable, highly informal sectors) in some countries in the early 1990s, changes in labor market and social security legislation or weakened enforcement capabilities, and to the increased availability of noncontributory social protection schemes for informal workers. In the meantime, poorly designed social security systems continued to tax heavily workers in the formal sector. Indeed, if informality increased in many countries during a decade that exhibited modest growth due at least partially to a combination of policy missteps, then a shift toward better policies at least can reverse these upsetting trends. Furthermore, although it appears that inequality and informality share important causal determinants, Chile shows that strong and more fair institutions and a fall in informality can be built even in the midst of high income inequality. Quoting Hirschman (1971) again, we find a “bias for hope”—good policies can have important effects.

**Summing up: Policy implications of the report**

Achieving significant reductions in present informality levels will require, first and foremost, actions to increase the aggregate productivity in the economy. A more enabling investment climate will permit formal firms to expand and pay higher wages. Raising human capital levels, especially for the poor, will permit more workers to find remunerative jobs in a more dynamic formal sector. Without such improvements in aggregate productivity, we will continue to find a very large number of microfirms, characterized by high turnover, weak growth prospects, and low productivity, that would see little benefit in engaging with formal
institutions. Without generalized improvements in human capital, many unskilled workers would continue to prefer self-employment, even if their earnings are low, because the jobs they could find in the formal sector would also deliver very low earnings. Such improvements in human capital have to be synchronized with those in the investment climate, as stressed in previous studies (particularly, de Ferranti et al. 2003), because otherwise the demand for more skilled workers will not grow at the same speed as the increase in supply—thereby depressing skill premiums (for instance, to secondary education) and further eroding incentives to invest in education.

However, there are many things that can be done to change the balance of incentives for those workers and small firms whose implicit cost–benefit estimates place them close to the margin between formality or informality. The same can be said of larger firms that remain partially informal. To have a significant effect, such actions normally require a good balance of carrots (reforms and actions to facilitate, reduce the costs, and increase the benefits of formalization) and sticks (enhanced, evenhanded enforcement of such improved laws and regulations). Furthermore, those excessive regulations and taxes that create some degree of labor market segmentation, as evidenced in most countries at least during some periods, need to be reduced. We discuss below some policy changes that may be especially promising in particular circumstances.

Achieving a deeper change in incentives also requires actions to change the pervasive culture of noncompliance that we observe in most countries in the region. Because such social norms are, in part, the result of a lack of trust in the effectiveness of the state and the equity of its actions, overcoming the culture of informality probably requires major improvements in the quality and fairness of state institutions and policies. In short, it requires building an effective and inclusive social contract in which the great majority of individuals feel compelled to participate and comply with state mandates.

Reforming labor market policies to increase productivity of the formal and informal sectors

The findings of this report suggest that labor market policies are important determinants of informality, working through three channels. First, excessive labor costs, whether arising through labor legislation or unrealistic
union demands (such as exaggerated minimum wages, severance costs, or labor taxes and contributions), depress the number of jobs in the formal sector, often creating the classic segmented market. Other recent reports from the World Bank—“Minimum Wages and Social Policies: Lessons from Developing Countries” (Cunningham 2007b) and “Job Creation in Latin America and the Caribbean” (World Bank 2007)—as well as the Inter-American Development Bank (IDB) (2006) publication Good Jobs Wanted, have investigated in detail the trade-offs encountered in offering strong protections to some workers at the possible expense of excluding others (see also de Ferranti et al. 2001). Minimum wages in most countries are not extremely binding, but in some—such as Colombia—they seem to be a deeply segmenting force that begs for moderation. Higher non-wage burdens on formal jobs in Brazil, Colombia, and Peru appear responsible for substantial declines in formal employment. Further, the experience in the OECD countries suggests that such regulations have a heavy exclusionary impact on young people who are trying to find jobs and who, in Latin America and the Caribbean, are especially overrepresented among the involuntary informal salaried. Nor does the evidence of a very high degree of integration of the formal and informal sectors in some other countries in the region necessarily imply satisfactory labor codes. Latin America’s globally very high levels of severance costs, for example, may substantially reduce job creation arising from growth without necessarily segmenting the market. Furthermore, as in the case of minimum wages, regulations sometimes can be binding in practice for the informal salaried sector and may inhibit job creation there.

Second, legislation can create incentives for voluntary informality. The design of social safety nets and labor legislation needs to consider a more integrated view of the labor market, taking into account the cost–benefit analysis that workers and firms make in deciding whether to interact with formal institutions. High labor taxes or contributions that do not correspond to benefits that workers value cause workers to opt out of the formal labor market. The difficulties of managing work and children under rigid formal work contracts also lead young mothers to opt for informal independent work offering more flexibility.

Third, the effect of labor market institutions on productivity growth has probably been underemphasized. Theory and anecdotal evidence suggest that excessive restrictions on job reallocation or destruction for just cause, or other related government- or union-induced inflexibilities, may have a disincentive effect on technology adoption, which accounts for up to half of the differences in levels of economic development. And, as shown in this report, the level of economic development is the most important determinant of observed informality levels.

Overall, the present constellation of often well-intended but heavy-handed labor regulations poorly serves workers and firms, and both could benefit from substantial reform. In particular, stronger enforcement of a redesigned labor code that combines strengthened safety nets, well-designed worker protections, and worker representation with the flexibility that firms need to adapt in a global economy has the potential to expand formal employment and reduce opting out. Simply tightening the enforcement of existing laws, particularly in the largely informal microfirm sector, may just eliminate jobs—many of which the chapters in this volume will show to be of good quality when measured by the worker’s overall welfare. At the other extreme, attempting to reduce the weight of labor legislation by creating special classes of less protective contracts can be problematic. When well designed, such contracts may offer flexibility that helps young people enter the market. However, they can often effectively create a parallel, unregulated “formal” sector that displaces formal contracting. That can lead to higher job turnover and to diminished incentives for training and may contribute to the overall culture of informality. Provisions to accommodate different non-wage costs for smaller firms and flexibility in benefits plans (such as simplified health/pension plans) may offer an extension of the overall rubric of labor protections without prejudicing the viability of these firms. Perhaps more flexible work schedules, or enhanced availability of day care, would keep more women in the formal sector, although care must be taken to avoid measures that might lead firms to discriminate against women in hiring as a result. Finally, institutional strengthening (staffing, training, technical assistance) of the labor ministries and coordinating of relevant public agencies (social security administration, enterprise development agencies, and competitiveness councils) are needed so that those ministries and agencies can assume their increasingly more complex role of facilitating labor productivity growth.

Informality sharply decreases with education, partly because the opportunity cost of being independent rises. However, the substandard education and training systems in the Latin American and Caribbean region both impede
the growth necessary to generate jobs in the more modern sector of the economy and reduce workers’ attachment to it. Furthermore, the poor signaling of education quality that results from a lack of uniform certification or accreditation impedes the entry of young workers into formal jobs. Remediying these failures, perhaps along with an expansion of intermediation services, may reduce the information asymmetries that young workers face. Further discussion of necessary reforms in this area is offered in the regional report “Raising Student Learning in Latin America and the Caribbean: The Challenge for the 21st Century” (Vegas and Petrow 2007). Ongoing upgrading of the workforce through training, particularly in rapidly evolving industries, is a central element of the national innovation system, and is critical to developing skills used in the modern sector of the economy and to promoting productivity growth. Training systems in the region, however, need to be more competitive and responsive to market demands.

In sum, the high rate of informal employment in some cases reflects classic segmentation, but in others it simply reflects the high costs and small benefits of employment in the formal sector. Labor regulations need to allow for productivity growth in both sectors, while revisiting the design of regulations and social protection systems that provide incentives for firms and individuals to become informal.

**Reengineering social protection to cover all citizens**

Central to this agenda is the need to rethink and, in fact, reengineer social protection policy and programs in much of Latin America and the Caribbean. Poor access to basic risk management instruments, coupled with poor design of social security schemes, serves workers poorly and provides an incentive to be informal. Fundamentally, this may require rethinking the traditional model of social protection in which protection depends on the specific form of the labor contract. A broader notion of who has access to basic risk management instruments is needed—one based on ensuring the basic protection and welfare of countries’ citizens rather than of “workers” as traditionally and narrowly defined.

Drawing insights from the economics of insurance, this report outlines a long-term vision for social protection reform in the region. In the case of health care, because shocks that go “uncovered” can impose significant external costs on society, there is a case for providing a package of minimum essential direct cover, de-linked from the labor contract and financed through general taxation. In the case of old-age security, there is also a case to provide essential cover in the form of a poverty prevention pension targeted toward the poor as part of a broader multipillar pension system that includes provisions for individual retirement savings. The social costs associated with people falling into poverty in old age create a clear risk management rationale for providing minimum old-age support de-linked from the labor contract; nonetheless, the high probability of income loss in old age suggests that saving should play the main role in earnings replacement during old age.

For a number of reasons, including those related to fiscal and institutional capacity, movement to provide essential cover in health care and old-age security, de-linked from the labor market and financed by general taxes, represents a long-term agenda for many countries in the region. It is important, therefore, for countries to orient their short-to-medium-term policy agendas in ways that are consistent—or at least *not inconsistent*—with their long-term vision. This will be critical if the region’s governments are to ensure that the objectives of social policy—and particularly social risk management—are well aligned with those of higher productivity and growth.

To this end, there will be high returns to governments in the region undertaking step-by-step reforms to improve the efficiency of existing programs as well as to establish greater consistency and incentive compatibility across programs. Several sets of actions will contribute to short-term improvements in social protection while moving countries in the direction of achieving essential cover over the long term. These actions would include efforts to improve the cost–benefit ratios of programs in several ways. First, complex, multidimensional social security benefit packages should be unbundled to focus on increasing access and quality of those programs with high public goods content (for example, health care, old-age security). Second, efforts should be made to improve program quality and benefits via microefficiency reforms in health care and country pension systems. Third, program design should be strengthened—for example, by revising overly burdensome pension-vesting periods, fostering benefits portability, eliminating double payments for health insurance, and so on—to account for and enable greater worker mobility. Finally, rules, eligibility requirements, and benefits levels across programs and institutions of social security and
social assistance should be made consistent and compatible with incentives. Such types of measures will provide the foundation for more effective social protection for all citizens and help strengthen the alignment of social and economic policy objectives.

**Improving opportunities for workers in the formal sector while reducing barriers to business formalization**

As suggested above, the fact that few micro firms grow from small informal entities to large formal firms can be explained in two complementary ways. On one hand, the presence of low opportunity costs for entry into the sector could be to blame because it would lead to a predominance of low-productivity businesses with low growth prospects and high failure rates. In this context, policy makers wishing to reduce informality should focus not only on altering the direct costs and benefits of formality but also on altering the drivers of formal sector productivity, including measures to improve the investment climate and policies aimed at increasing human capital accumulation. On the other hand, however, policy-induced barriers to formalization could impede microfirms’ access to technologies, markets, and government services, and that would explain at least some of their low growth and job creation rates. In this second interpretation, reductions in informality and improvements in microfirm performance could be achieved by lowering statutory burdens to formalization and implementing administrative simplification programs aimed at reducing the transaction costs associated with operating legitimate businesses. In particular, programs that facilitate business registration—for instance, through the use of Internet-based technologies and one-stop-shops—should lead to an increase in formality rates and improved microfirm performance.

In practice, the existing evidence from Brazil and Mexico suggests that administrative simplification programs do lead to increases in formal firm registration rates, with large consequent improvements in the revenue- and employment-generating capacity of the corresponding businesses. However, the number of positively affected firms is relatively small in comparison with the overall size of the informal microfirm sector. Moreover, at least in the case of Mexico, it appears that most of the newly registered firms are new entrants—that is former wage workers who decide to open new formal businesses—rather than existing informal firms that become formal as a result of lower registration costs. Hence, although high entry costs may keep some entrepreneurs from starting new formal businesses, the available evidence suggests that just lowering administrative barriers to business registration may not have a major impact on aggregate levels of informality. This finding does not imply that those interventions are not important. First, lower entry costs do induce at least some entrepreneurs to open new formal businesses, and their improved performance probably would be sufficient justification for the corresponding reforms. Second, the impact of administrative simplification programs may be larger when accompanied by other complementary measures aimed either at increasing the potential benefits of joining the formal sector or at reducing the costs of regulatory compliance—beyond the facilitation of firm registration.

With regard to the first alternative, recent evidence from randomized experiments suggests relatively high returns to capital among very small Mexican microenterprises, and this suggests that considerable increases in income could be obtained through measures to increase small businesses’ access to bank credit and other forms of external finance. Similarly, in principle, formality could be made more attractive by improving the provision of business development and training services available to formal firms, and by facilitating access to product markets through public procurement opportunities and supplier development programs aimed at increasing links with larger private firms. Other ways of making formality more attractive include improvements in the quality of legal services available to small businesses so that they may find it less risky to expand beyond local markets, and creating mechanisms to provide information to entrepreneurs wishing to formalize their businesses (from advisory services on taxes and regulations to information on financial and nonfinancial services available to them).

As for measures to reduce other costs of operating legitimate businesses, governments should consider performing comprehensive regulatory reviews aimed at eliminating unnecessary and costly bureaucratic requirements. In this respect, the challenge is that of distinguishing relevant from anachronistic regulations, as well as identifying those regulations that significantly increase the costs of operating private businesses and are not justified by legitimate public interests, such as the protection of public safety or the environment. If successful, such regulatory reforms may help reduce informality both by increasing job creation in the
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formal sector and by reducing regulatory noncompliance among formally registered, medium-size and large firms—for example, tax and social security evasion. Indeed, although cross-country differences in the size of the informal sector are largely explained by countries’ general levels of development—which, in turn, are driven partially by the quality of governance and institutions—there is also evidence that, for given levels of per capita income, informality tends to be higher where regulatory burdens are heavier. Moreover, not only the quantity but also the quality of regulations appears to matter, as is illustrated by the finding that firms facing higher levels of corruption are more likely to evade taxes and social security. In that context, the objective should be to eliminate unnecessary regulations while enhancing their evenhanded enforcement and streamlining administrative processes to reduce excessive red tape.

Overall, a wider and integrated approach appears to be necessary to switch the incentives of a large fraction of informal firms in the direction of formality. Such an approach would likely have to combine carrots (such as lower costs of formalization, better and more efficient government services, and greater access to government- and market-provided services for formal firms) with sticks (for example, increasing evenhanded enforcement of regulations and, hence, the expected cost of being caught). The correct mix of policies, however, is likely to vary across countries and over time, depending on the relative importance of the various determinants of informality. Moreover, policies aimed at reducing firm informality should be considered in conjunction with the labor market and social protection issues associated with the possibility of large contingents of previously informal workers shifting to other segments of the labor market.

Simplifying tax laws, facilitating compliance, and strengthening enforcement

As mentioned above, underreporting of sales and incomes for tax purposes is common even in large firms, although the degree of compliance and its relation with firm size vary widely among countries. To deal successfully with this dimension of informality, there is also a need for an integrated approach consisting of both sticks and carrots.

First, there is substantial room for measures that fall within the traditional monitoring and “punishment paradigm” of tax compliance. In most countries, improvements are needed in the three main aspects of tax administration: taxpayer registration, audit, and collection. Taxpayer registration, audit, and collection. Taxpayer registration, audit, and collection can be enhanced through better use of third-party information (for example, cross-references between tax reporting, social security records, and data from the financial system). Audits can be made more effective by the adoption of modern audit technology, such as has been the case in Chile and Spain. In most countries there is scope for reducing administrative and compliance costs and increasing collections through changes in tax structure, combining reductions in marginal tax rates with the elimination of exemptions and privileged regimes that create loopholes in value-added, income, and property taxes, and simplification of deductions. Collections can also be increased by facilitating payments through the banking system, relying more heavily on source withholding and applying non-harsh penalties for noncompliance often and consistently. Finally, criminalization of certain tax offenses in combination with a modernized tax administration agency has been credited with playing a key role, among other factors, in Spain’s success in the late 1970s and 1980s in drastically reducing tax evasion and eventually doubling the ratio of tax revenue to gross domestic product.

Second, reforms should also emphasize the “service paradigm” with policies to enhance the role of the tax administration as a facilitator and a provider of services to taxpayer-citizens. Promoting taxpayer education and developing taxpayer services in filing returns and paying taxes, broadcasting advertisements that link taxes with government services, stimulating voluntary compliance by lowering compliance costs, simplifying taxes and their payment, and promoting a taxpayer—and a tax administrator—“code of ethics” have proved to be useful complementary measures to the punishment paradigm to enhance compliance. The use of semiautonomous revenue authorities has been shown in several countries to improve tax administration with a more service-oriented approach to tax enforcement.

The service paradigm fits squarely with the perspective that emphasizes the role of social norms in tax compliance. Experience from other countries shows that a government’s commitment to evenhandedly enforce the tax laws while facilitating taxpayer compliance can have an important effect on the pervasive culture of noncompliance found in many countries in the region. Disclosure of public expenditure information, and the participation of and supervision by citizens—that is, “voice”—in the way taxes will be spent, may also help increase trust in the state and may contribute to social norms of compliance. These factors have been credited with success in increasing tax
Brazil and Colombia results partially from well-intentioned policies emerging from the constitutional exercises that strove to be more inclusive. Hence, however well meaning or inclusive policies may be, they must be well designed. The inclusive state must also be a competent state.

Informality and the development agenda

Informality reflects underdevelopment, and this report seeks to tease out some of the interactions and directions of causality between the phenomena of informality and development. There is evidence that, in part, informality is merely a stage in the development process: the ubiquitous microfirm reflects the unattractive options in the small modern sector and the traditional reliance on family and community. However, other evidence suggests that, in part, informality is a canary in the coal mine—the symptom of poor policies and, more profoundly, a lack of confidence in the state and perhaps in our fellow citizens. To return to Hirschman, confronted with a lack of voice in and relevance of the state, Latin Americans take their business elsewhere; and, in doing this, they further undermine the region’s growth prospects. Hence, redressing the causes of high informality is part and parcel of the broader development agenda.

Note
1. See de Ferranti et al. (2000) for an earlier application of the economics of insurance in the region.

References


